Strategic Management

Strategy Formulation and Implementation

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Both of The University of South Carolina

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Preface

Strategic Management: Formulation and Implementation is a book which was designed to help students learn the critical business skills of planning and managing strategic activities. It incorporates three teaching approaches: text, Cohesion Cases, and business case studies.

The *text* portion of this book attempts to provide the student with a readable, up-to-date introduction to the management of strategy in the business enterprise. We have tried to integrate the work of strategic management theorists, practitioners, and researchers with a strong emphasis on real-world applications of strategic management concepts. To further this aim, we have included "Strategy in Action" reports in each chapter which give current examples of the application of key concepts by well-known business firms.

The structure of the text material is guided by a comprehensive model of the strategic management process. The model helps students to acquire an executive-level perspective on strategy formulation and implementation. It provides a visual display of the major components of the entire process and shows how they are conceptually related and how they are sequenced throughout the process.

The major components of the model are each discussed in depth in separate chapters, thereby enabling students to acquire detailed knowledge and specific skills within a broad framework of strategic management. The use of the model is also extended to the Cohesion Cases and the business case studies, where students are guided in their case analyses to pursue disciplined, systematic, and comprehensive studies of actual strategic dilemmas.

The *Cohesion Case* offers a particularly unique feature designed to aid the student and teacher of strategic management and business policy. We have taken a well-known, multi-industry firm—Holiday Inns, Inc.—and used it as the basis of an in-depth case study to illustrate in detail the application of the text material. To do this, we provide a Cohesion Case section at the end of each chapter which applies the chapter material to the company. The Holiday Inns, Inc. case offers a clear illustration of the corporate, business, and functional levels of strategy—so important to the understanding of strategic management in today's corporate environment.

The Cohesion Case offers several advantages for both the student and the teacher:

It provides a continuous illustration of the interdependence of the various parts of the strategic management process by using the same enterprise throughout the chapters.

It can provide a useful aid to the student in understanding the text material, when the primary emphasis in the course is to be on case studies or other nontext analysis.

It aids the student in preparing for the case analysis component of the course, in the event that the instructor prefers to emphasize the conceptual material.

It offers an in-depth basis for class discussion of strategic management concepts, application, and ideas for any classroom pedagogy.

Finally, to maximize the value of the Cohesion Case concept for both student and teacher, we have included a second Cohesion Case at the end of the text portion of this book. It applies the strategic management concepts to a single business firm—Congress Motel—in the same chapter-by-chapter format. This alternate Cohesion Case applies strategic management at the business and functional strategy levels, thus offering a simplified illustration vehicle for teaching business policy and strategic management.

The *business case studies* chosen for the text offer students a wide exposure to a systematically selected cross section of strategic management situations. Among the 30 cases are studies of the lodging and fast-food industries each of which contain industry notes and detailed cases on individual companies operating within those industries. Three other businesses are studied through multiple cases thereby providing students with the opportunity to investigate patterns of strategy formulation and implementation over time and in changing environments. Other cases enable the study of comparative differences between large and small firms, service and manufacturing companies, and retail and wholesale businesses. In addition, the cases share four characteristics: they address strategic management issues, they describe concerns of profit-oriented businesses, they emphasize the need for a degree of quantitative analysis, and they have been classroom tested to help assure their educational value.

The development of this book was aided by many friends and colleagues. We are grateful to Jack Ruhe of St. Mary's College for his contributions of focus, insight, and examples of strategic behavior to Chapter 5. Larry Cummings of the University of Wisconsin–Madison, Liam Fahey of Northwestern University, Don Hambrick of Columbia, and Kirby Warren of Columbia deserve our special thanks for their helpful and thorough review of each chapter. Cynthia Montgomery of Michigan State University and Bill Warren of the College of William and Mary also provided useful review on selected

portions of the book. The valuable recommendations of these outstanding scholars have added quality to our final product.

The stimulating environment at the University of South Carolina has also contributed to the development of this book. Thought-provoking discussions with our business policy colleagues Alan Bauerschmidt, Carl Clamp, Greg Dess, Herb Hand, John Logan, and Bob Rosen provided numerous useful ideas. Likewise, we want to thank James F. Kane, dean of the College of Business Administration and James G. Hilton, our associate dean, for their interest and generous support. Our sincere appreciation also goes to the secretaries who helped to prepare our manuscript: Patti Bearden, Connie Cale, Linda Doar, Frances Donnelly, Kay Elledge, Linda Grubbs, Kim Gypin, and Jacqueline Y. Haile.

In using this text, we hope that you will share our enthusiasm both for the rich subject area of strategic management which we have attempted to portray and for the learning approach which we have taken.

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Contents

part one

Overview of strategic management

THE first two chapters of this text provide a broad introduction to strategic management. We want to help you become acquainted with the nature, need, benefits, and terminology of the processes which produce and implement the major plans that direct business activities. Subsequent chapters then build on a common understanding as a basis for providing greater detail.

In Chapter 1, "The Nature and Value of Strategic Management," we emphasize the practical value of a strategic management approach to a business organization. We review the actual benefits for companies which have instituted strategic management. And we present the critical activities of strategic management in addition to a set of dimensions that can be used to distinguish strategic decisions from other planning tasks of the firm.

Chapter 1 stresses the key point that strategic management activities are

undertaken at three levels in many companies: corporate, business and functional. The distinctive characteristics of strategic decision making at each of these levels are discussed as the basis for observations throughout the book of the differential impact which the activities at different levels have on company operations.

The extent of desirable formality in strategic management is another key point in the chapter as is the alignment of strategy makers with particular activities in the overall process of strategy formulation and implementation. We reach the conclusions that it is possible to assign areas of decision-maker responsibility and to suggest an appropriate degree of formality in strategic activities. The determining factors for these conclusions are discussed in detail.

A final section in Chapter 1 reviews the results of research in business organizations. The studies demonstrate convincingly that companies which undertake strategic management processes often enjoy financial and behavioral benefits that justify the additional costs involved.

Chapter 2 presents a model of the strategic management process. It is representative of the approaches currently used by strategic planners and serves as an outline for the remainder of the book. That is, each subsequent chapter is devoted to an in-depth discussion of one of the major components of the strategic management model. Each of the individual components is carefully defined and explained in Chapter 2. Attention is also given to understanding the integrative process by which each of the components is blended together to produce cohesive and balanced results from the system. The chapter concludes with a discussion of the practical limitations of the model. In this way, you will be alert to the advisability of tailoring the general recommendations suggested in each chapter to the unique situations which you confront in actual business practice.

chapter 1

The nature and value of strategic management

THE practice of strategic management is recognition of the complexity and sophistication demanded by business decision making.

Managing the various and multifaceted internal activities of a company is only part of the modern executive's responsibilities. The firm's immediate external environment poses a second set of challenging factors. It includes competitors whenever profits seem possible, suppliers of ever more scarce resources, government agencies which watch for adherence to an ever increasing number of regulations, and customers whose often inexplicable preferences must be anticipated. Additionally, there is a remote external environment which contributes to a general yet pervasive climate for business. It consists of economic conditions, social change, political priorities, and technological developments. An executive must anticipate, monitor, assess, and incorporate each of these factors in top-level decision making. However, the attention to all of these influences is often subordinated to the fourth major consideration in executive decision making—the multiple and often mutually inconsistent objectives of the stakeholders of the business: its owners, top managers, employees, communities, customers, and country.

To deal effectively with all of the considerations which affect the ability of a company to grow profitably, executive officers design strategic management processes which they feel will facilitate the optimal positioning of the firm within its competitive environment. Such positioning is made possible because of the value of these processes both in more accurately acting in anticipation of environmental changes and in improving preparedness for reacting to unexpected internal or competitive demands.

The sophistication of broad-scope, large-scale management processes has increased dramatically since the end of World War II, principally as a reflection of the increases in the size and number of competing firms; of the heightened intervention of government as a buyer, seller, regulator, and competitor in the free enterprise system; and of the greater involvement of businesses in international trade. Perhaps the most significant improvement

came in the decade of the 1970s, as the "long-range planning," "new venture management," "planning, programming, budgeting," and "business policy" approaches blended with a greater-than-ever emphasis on environmental forecasting and the addition of external to internal considerations in the formulation and implementation of plans. This approach is known as "strategic management" or as "strategic planning."[1]

Strategic management is defined as the set of decisions and actions resulting in the formulation and implementation of strategies designed to achieve the objectives of the organization. It involves attention to no less than nine critical areas. (See Figure 1–1.)

1. Determination of the mission of the company, including broad statements about its purpose, philosophy, and goals.
2. Development of a company profile which reflects its internal condition and capability.
3. Assessment of the company's external environment, both in terms of competitive and general contextual factors.
4. Interactive opportunity analysis of possible options uncovered in the matching of the company profile with the external environment.
5. Identification of the desired options uncovered when the set of possibilities is considered in light of the company mission.
6. Strategic choice of a particular set of long-term objectives and grand strategies needed to achieve the desired options.
7. Development of annual objectives and short-term strategies which are compatible with the long-term objectives and grand strategies.
8. Implementation of strategic choice decisions based on budgeted resource allocations and emphasizing the matching of tasks, people, structures, technologies, and reward systems.
9. Review and evaluation of the success of the strategic process to serve as a basis of control and as an input for future decision making.

Dimensions of strategic decisions

What decisions facing a business are strategic and therefore deserve strategic management attention? Typically, strategic issues have six identifiable dimensions.

1. Strategic issues require top management decisions. Strategic decisions overarch several areas of a firm's operations. Therefore, top management involvement in decision making is imperative since only they have the perspective to understand and anticipate broad implications and ramifications, and only they have the power to authorize necessary resource allocations needed for implementation.

[1] In this text the term *strategic management* is used when referring to the broad overall process, since to some scholars and practitioners the term *strategic planning* connotes only the formulation phase of total management activities.

figure 1-1
Strategic management responsibilities

What would a practicing executive say are the responsibilities of management in the strategy process? One answer comes from Marvin Bower, the long-time managing director of McKinsey and Company, one of the world's largest and most respected management consulting firms. Bower lists 14 processes for which management at some level in the organization must claim responsibility.

1. Setting the mission. Deciding on the business or businesses in which the company or division should engage and on other fundamentals that shall guide and characterize the business, such as continuous growth. A mission is typically enduring and timeless.

2. Developing a company philosophy. Establishing the beliefs, values, attitudes, and unwritten guidelines that add up to "the way we do things around here."

3. Establishing objectives. Deciding on achievement targets with a defined time range or narrower in scope than the mission, designed to aid in making operational plans for carrying out strategy.

4. Planning strategy. Developing concepts, ideas, and plans for achieving objectives successfully, and for meeting and beating competition. Strategic planning is part of the total planning process that includes management and operational planning.

5. Establishing policies. Deciding on plans of action to guide the performance of all major activities in carrying out strategy in accordance with company philosophy.

6. Planning the organization structure. Developing the plan of organization—the harness that helps people pull together in performing activities in accordance with strategy, philosophy, and policies.

7. Providing personnel. Recruiting, selecting, and developing people—including an adequate proportion of high-caliber talent—to fill the positions provided for in the organization plan.

8. Establishing procedures. Determining and prescribing how all important and recurrent activities shall be carried out.

9. Providing facilities. Providing the plant, equipment, and other physical facilities required to carry on the business.

10. Providing capital. Making sure the business has the money and credit needed for physical facilities and working capital.

11. Setting standards. Establishing measures of performance that will best enable the business to achieve its long-term objectives successfully.

12. Establishing management programs and operational plans. Developing programs and plans governing activities and the use of resources which—when carried out in accordance with established strategy, policies, procedures, and standards—will enable people to achieve particular objectives. These are phases of the total planning process that includes strategic planning.

13. Providing control information. Supplying facts and figures to help people follow the strategy, policies, procedures, and programs; to keep alert to forces at work inside and outside the business; and to measure their own performance against established plans and standards.

14. Activating people. Commanding and motivating people up and down the line to act in accordance with philosophy, policies, procedures, and standards in carrying out the plans of the company.

Source: Adapted with some modification to ensure consistency in terminology from Marvin Bower, *The Will to Manage: Corporate Success through Programmed Management* (New York: McGraw-Hill, 1966), pp. 17–18.

2. Strategic issues involve the allocation of large amounts of company resources. Strategic decisions characteristically involve substantial resource deployment. These people, physical assets, or monies must be either redirected from internal sources or secured from outside the firm. In either case, strategic decisions commit a firm to a stream of actions over an extended period of time thus involving substantial resource support.

3. Strategic issues are likely to have a significant impact on the long-term prosperity of the firm. Strategic decisions ostensibly commit the firm for a period of approximately five years; however, the time frame of impact is often much longer. Once a firm has committed itself in a major way to a particular strategic option, its competitive image and advantages are usually tied to that strategy. Firms become known in certain markets, for certain products, with certain characteristics. To shift from these markets, products, or technologies through the adoption of a radically different strategy would jeopardize the progress which they had previously made. Thus, strategic decisions have enduring impacts on the firm—for better or worse.

4. Strategic issues are future oriented. A major distinguishing feature of strategic decisions is they are made based upon what managers anticipate or forecast rather than know. Emphasis is placed on the development of projections which will enable the firm to select the most promising strategic options. In the turbulent and competitive free enterprise environment, a successful firm must take a proactive stance toward change.

5. Strategic issues usually result in major multifunctional or multibusiness consequences. A strategic decision is a coordinative one. Decisions about such factors as customer mix, competitive emphasis, or organizational structure necessarily involve a number of a firm's strategic business units (SBUs), functions, divisions, or program units. Each of these areas will be affected by the allocation or reallocation of responsibilities and resources related to the decision.

6. Strategic issues necessitate consideration of factors in the firm's external environment. All business firms exist within an open system. They impact and are impacted by conditions external to the firm and largely beyond their control. Therefore, if a firm is to be successful in optimally positioning itself in future competitive situations, its strategic managers need to look beyond the limits of the firm's own operations. They must consider what relevant others are likely to do, e.g., competitors, customers, suppliers, creditors, government, and labor.

Three levels of strategy

Business firms typically exhibit three levels in their decision-making hierarchy. At the top is the corporate level, composed principally of members of the board of directors and the chief executive and administrative officers. They bear the responsibility for the financial performance of the corporation as a whole and for achieving the nonfinancial goals of the firm, e.g., corpo-

rate image and social responsibility. To a large extent, their orientations reflect the concerns of stockholders and of the society at large. Particularly in multibusiness firms, it is their duty to determine in what businesses the company should be involved. Further, they set objectives and formulate strategies which overarch the activities of individual businesses in the corporation and of their respective functional areas. By adopting a portfolio approach to strategic management, corporate level strategic managers attempt to exploit their distinctive competencies within their industries while typically planning with a five-year time horizon.

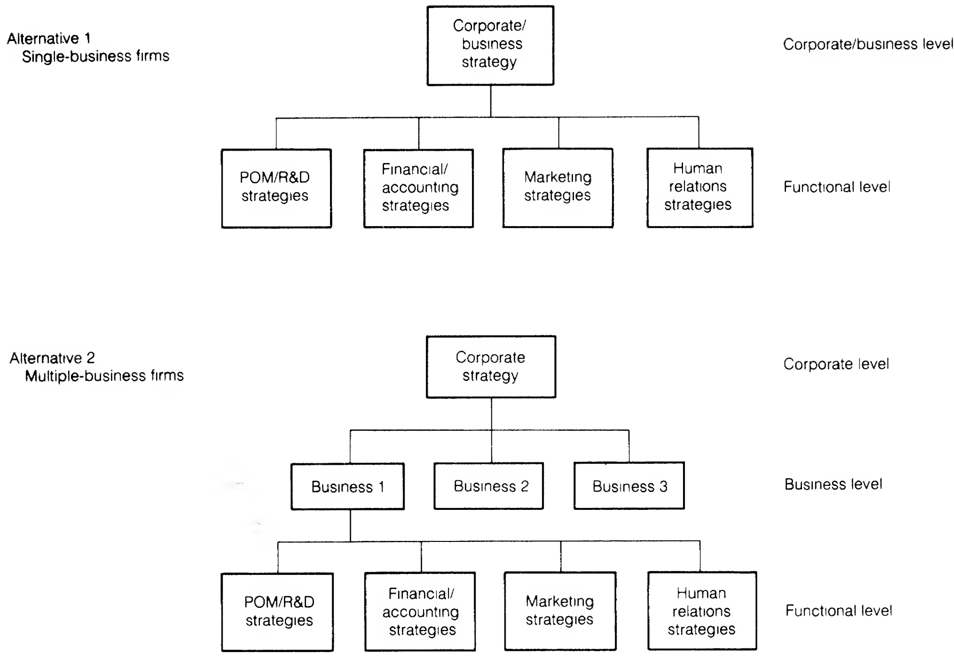
The second rung of the decision-making hierarchy is the business level, which is composed principally of business and corporate managers. They must translate the general statements of direction and intent which were generated at the corporate level into more concrete and operational objectives and strategies for their individual business divisions or SBUs. In essence, business level strategic managers must determine on what basis the company can compete in the selected product-market area. While so doing, they strive to identify and secure the most profitable and promising market segment. This market segment is the fairly unique piece of the total market which the business can claim and defend because of its competitive advantages. Every corporation, even the largest multinational, depends on the strength of their market segments as the basis of its continuing viability.

The third rung of the strategic decision-making hierarchy is the functional level, which is composed principally of activity managers of product, geographic, and function areas. It is their responsibility to develop annual objectives and short-term strategies for such areas as production, operations management, and research and development; financial and accounting; marketing; and human relations. However, their greatest responsibilities are in the implementation or execution of the company's strategic plans. While corporate and business-level managers center their planning concerns on "do the right things," functional-level managers must stress "doing things right." Thus, they directly address such issues as the efficiency and effectiveness of production and marketing systems, the quality and extent of customer service, and the success of particular products and services in increasing their market shares.

Figure 1–2 depicts the three levels of strategic management as they are actually structured in practice. In alternative 1, where the company is engaged in only one business, the corporate and business-level responsibilities are concentrated in a single group of directors, officers, and managers. This particular strategic management structure is nearly synonymous with the organizational formats of small businesses, which constitute approximately 95 percent of all business organizations in the United States.

Alternative 2 displays a classical corporate structure which is comprised of three fully operative levels. Providing the suprastructure is the corporate level, with the superstructure coming from the business level to provide direction and support for functional level activities.

figure 1–2
Alternative strategic management structures



The approach taken throughout this text is best depicted by alternative 2. Thus, whenever appropriate, the topics covered in the text will be addressed from the perspective of all three levels of strategic management. By so doing, you will be exposed to one of the most comprehensive and up-to-date discussions of the strategic management process.

Characteristics of strategic management decisions

The characteristics of strategic management decisions vary with the level of strategic activity being considered. As shown in Figure 1–3, corporate level decisions tend to be more value oriented, conceptually based, and less concrete than are those pertaining to business or functional level strategy formulation and implementation. Corporate level decisions are also characterized by greater magnitudes in risk, cost, and profit potential, as well as by longer time horizons and greater needs for flexibility and for external infusions of resources. These characteristics are logical consequences of the more far-reaching, futuristic, innovative, and pervasive nature of corporate level strategic activity. Examples of corporate level decisions include the choice of business in which to engage, dividend policies, sources of long-term financing, and priorities for the growth.

figure 1-3
Characteristics of strategic management decisions at alternative levels

	Level of strategy		
Characteristic	*Corporate*	*Business*	*Functional*
Type	Conceptual	Mixed	Operational
Definitions	Intangible	Mixed	Concrete
Measurability	Value judgments dominant	Semiquantifiable	Usually quantifiable
Frequency	Periodic or sporatic	Periodic or sporadic	Periodic
Adaptability	Low	Medium	High
Relation to present activities	Innovative	Mixed	Supplementary
Risk	Wide range	Moderate	Low
Profit potential	Large	Medium	Small
Cost	Major	Medium	Modest
Time horizon	Long range	Medium range	Short range
Flexibility	High	Medium	Low
Availability of resources	Partially available	Partially available	Usually available
Cooperation required	Considerable	Moderate	Little

At the other end of the continuum, functional level decisions principally address action-oriented or operational issues. Made periodically, they lead directly to the implementation of some part of the overall general strategy for the firm formulated at corporate and business levels. Therefore functional level decisions are relatively short range in their time horizon, involving low risk and modest costs because of substantial reliance on available resources. They usually determine actions requiring minimal company-wide cooperation which are supplemental to the functional area's present activities and which are highly adaptable to ongoing activities so that minimal cooperation is needed for their successful implementation. Because of their relatively concrete and quantifiable nature, functional level decisions receive critical attention and analysis despite their independently low comparative profit potential.

Some commonly encountered functional level decisions might include generic versus brand name labeling, basic versus applied R&D, high versus low inventory levels, general versus specific purpose production equipment, and close versus loose supervision.

Bridging corporate and functional level decisions are those made at the business level. As Figure 1-3 indicates, business level strategic decisions exhibit characteristics whose descriptors fall between the other two levels. For example, business level decisions are less costly, risky, and potentially profitable than corporate level decisions but more costly, risky, and potentially profitable than functional level decisions. Some frequently required business level decisions involve plant location, marketing segmentation and geographic coverage, and distribution channels.

Formality in strategic management

The extent of the formality of strategic management systems varies widely among companies. Formality refers to the degree to which the system is prespecified in terms of its membership, responsibilities, authority, and discretion in decision making. It is an important consideration in the study of strategic management because the degree of formality is usually positively correlated with the cost, comprehensiveness, accuracy, and success of planning.

The need for formality in a strategic management process is determined by a number of forces. As shown in Figure 1–4, the size of the organization, its predominant management styles, the complexity of its environment and its production processes, the nature of its problems, and the purpose of the planning system all combine in determining an appropriate degree of formality.

In particular, formality is often highly associated with two factors: size and stage of development of the company. Some firms, especially smaller ones, may adopt an entrepreneurial mode. Evaluation in this mode is very informal, intuitive, and limited in scope. At the other end of the spectrum, evaluation is part of a comprehensive, formalized, multilevel strategic planning system. This approach is used by large firms such as Texas Instruments and General Electric. Calling it the planning mode, Henry Mintzberg identified a third mode (the "adaptive mode") in the middle of this spectrum which he associated with medium-sized firms in relatively stable environments.[2] Firms in the adaptive mode identify and evaluate alternative strategies in close proximity to existing strategy. However, despite these generalities, it is not unusual to find different modes within the same organization. For example, Exxon might adopt an entrepreneurial mode in the development and evaluation of its solar subsidiary's strategy while the rest of the company follows a planning mode.

The strategy makers

The ideal strategic management process is developed and governed by a strategic management team. The team consists principally of strategic decision makers at all three levels in the corporation, e.g., the chief executive officer (CEO), the product managers, and the heads of functional areas. The team also relies on inputs from two types of support personnel: company planning staffs, when they exist, and lower-level managers and supervisors who provide data for strategic decision making and who have responsibilities for implementing strategies.

Because strategic decisions have such tremendous impact on a firm and because they require large commitments of company resources, they can

[2] H. Mintzberg, "Strategy Making in Three Modes," *California Management Review* 16, no. 2 (1973): 44–53.

figure 1-4
Forces influencing strategic management systems design

Toward more formality and details		*Toward less formality and details*
	Organization	
	Small one-plant companies	→
←	Large companies	
	Management styles	
←	Policymaker	
	Democratic-permissive	→
←	Authoritarian	
	Day-to-day operational thinker	→
	Intuitive thinker	→
	Experienced in planning	→
←	Inexperienced in planning	→
	Complexity of environment	
←	Stable environment	
	Turbulent environment	→
←	Little competition	
←	Many markets and customers	→
	Single market and customer	→
	Competition severe	→
	Complexity of production processes	
←	Long production lead times	
	Short production lead times	→
←	Capital intensive	
←	Labor intensive	
←	Integrated manufacturing processes	
	Simple manufacturing processes	→
←	High technology	
	Low technology	→
	Market reaction time for new product is short	→
←	Market reaction time is long	
	Nature of problems	
←	Facing new complex, tough problems having long-range aspects	
	Facing tough short-range problems	→
	Purpose of planning system	
←	Coordinate division activities	
	Train managers	→

Source: George A. Steiner, *Strategic Planning* (New York: Free Press, 1979), p. 54. Copyright © 1979 by the Free Press, a division of Macmillan Publishing Co., Inc. Reprinted with permission of Macmillan.

only be made by top managers at the appropriate levels in the organizational hierarchy. Figure 1–5 indicates the alignments between levels of strategic decision makers and the kinds of objectives and strategies for which they are typically responsible.

The use of company planning staffs has grown considerably since the 1960s. In large corporations the existence of planning departments, often headed by a corporate vice president for planning, is commonplace.

figure 1–5
Hierarchy of objectives and strategies

		Strategic decison makers			
Ends (What is to be achieved?)	*Means (How it is to be achieved?)*	*Board of directors*	*Corporate managers*	*Business managers*	*Functional managers*
Mission, including goals and philosophy*		√√	√√	√	
Long-term objectives*	Grand strategy*	√	√√	√√	
Annual objectives*	Short-range strategy*		√	√√	√
Functional objectives	Tactics			√	√√

*Indicates a principal topic in the study of strategic management.
Note: √√ indicates a principal responsibility; √ indicates a secondary responsibility.

Medium-sized firms frequently employ at least one full-time staff member to spearhead strategic data-collection efforts. Even in smaller or less progressive firms, an officer or group of officers designated as a planning committee is often given an assignment of spearheading the company's strategic planning efforts.

Precisely what are the responsibilities of strategic managers in the strategic planning process at the corporate and business levels? Figure 1–6 provides some answers. It shows that top management shoulders the responsibility for broadly approving each of the six major phases of planning which are listed. They are assisted in the execution of these responsibilities by the corporate planning department, staff or personnel, who actually prepare major components of the corporate plan. They also review, evaluate, and counsel on most major phases of the plan's preparation.

Figure 1–6 further shows that general managers at the business level have principal responsibilities for approving the conclusions of environmental analysis and forecasting, the establishment of business objectives, and the development of business plans which are prepared by staff groups. The figure clearly indicates the pervasive and potentially powerful influence of corporate planners in the overall strategic management process.

One final, but perhaps overriding, point must be made on the topic of strategic decision makers: a company's president or CEO characteristically plays the most dominant role in the process. In many ways this situation is desirable and reasonable. The principal duty of a CEO is often defined as that of giving long-term direction to the firm. the CEO is ultimately responsible for the success of the business and therefore of its strategy. Additionally, CEO's are typically strong-willed, company-oriented individuals with a high sense of self-esteem. Their personalities often inhibit them from delegating substantiative authority to others in the formulation of approval of strategic decisions.

However, when the dominance of the CEO approaches autocracy the effectiveness of the firm's strategic planning and management processes are likely to be greatly diminished. The advantages of a team-oriented, participative strategic system are obviously related inversely to the propensity of the CEO to make major strategic decisions single-handedly. For these reasons, the establishment of a strategic management system carries with it an implicit promise by the CEO to provide managers at all levels with the opportunity to play a role in determining the strategic posture of their firm. The degree to which the CEO fulfills the promise is often synonymous with the degree of success enjoyed through the use of the strategic management process.

The interactive and iterative flow of the strategic process

The strategic management process is sometimes misperceived as involving a unidirectional flow of objectives, strategies, and decision parameters from

figure 1–6
Responsibility relationships in strategic planning

	Corporate responsibility		Business responsibility		Functional responsibility
Planning activities	*Top management*	*Corporate planning department*	*General management*	*Staff groups*	*Departmental planning groups*
Establish corporate objectives	△				
Establish corporate objectives	●	●			
Set planning horizon	●		●		
Organize and coordinate planning effort		●			●
Make environmental assumptions	△	●	△	●	
Collect information and forecast					
Forecast sales	△		△	●	
Assess firm's strengths and weaknesses			△	●	
Evaluate competitive environment			△	●	
Establish business objectives	△		△	●	△
Develop business plans	△	○	△		△
Formulate alternative strategies		○		●	
Select alternative strategies		○	●		
Evaluate and select projects			△	●	
Develop tactics			△	●	
Revise objectives and plans if objectives are not met	△				
Integrate plans		●			
Allocate resources	△				
Review progress against the plan	●		●		
Evaluate plan's effectiveness		●			

Key: △ Approves.
○ Reviews, evaluates, and counsels.
● Does the work.

Source: Adopted with modifications from Ronald J. Kudla, "Elements of Effective Corporate Planning," *Long Range Planning*, August 1976, p. 89.

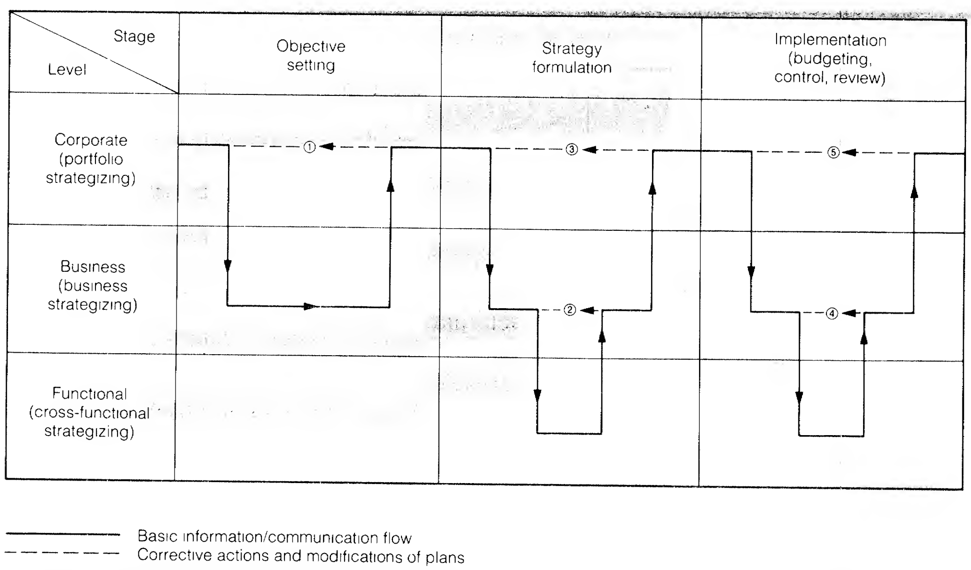
corporate to business to functional level managers. In fact, the process is highly interactive, that is, a company's process is designed to stimulate inputs from creative, skilled, and knowledgeable people throughout the firm. While it is certainly true that the strategic process is overseen by top managers—because of their broad perspective on the company and its environment—there are multiple opportunities for managers at all levels in the organization to participate in various phases of the total process.

Figure 1–7 provides an example of the basic, typical, interactive flow. As indicated by the solid-line path, strategic management activities tend to follow a formalized pattern of top-down/bottom-up interactions involving planners at all three levels of the firm.

As indicated by the five broken-line loops in Figure 1–7, the strategic management process is also iterative in nature. This means that strategic decisions are usually reached only after a trial-and-error method of perfecting planning ideas through an iterative process. Management expert Peter Lorange gives the following examples of the five interative loops:

> Loop 1: When the CEO receives inputs indicating where the businesses may be going, he may have to reconcile the emerging portfolio pictures with his initial tentative objectives. As a result he may ask one or more of the businesses to revise their inputs, and he may change his original tentative objectives as well. One or more iterations may be necessary before the loop is closed.

figure 1–7
Iterative loops in the strategic management process



Source: Adapted from Peter Lorange, *Corporate Planning: An Executive Viewpoint* (Englewood Cliffs, N.J.: Prentice-Hall, 1980), p. 61, © 1980, reprinted by permission of Prentice-Hall.

Loop 2: During the business manager's strategy formulation he may frequently go back to the functional departments and request revisions of particular programs in order to fit individual programs into a more coherent package from the business strategy viewpoint.

Loop 3: When the CEO receives the portfolio of business strategies he may have to cycle one or more of these back for revisions to achieve the desired portfolio strategy.

Loop 4: During the implementation cycle a business manager may have to recycle the functional implementation proposals so that the overall implementation plan attains the desired strategic properties, i.e., becomes a near-term reflection of the longer-term strategy.

Loop 5: Similarly, the CEO might want to call for revisions in one or more of the business implementation plans so that the final overall fit is achieved.[3]

The central point of this discussion is that the team concept in strategic processes is a critical and practiced feature. Managers at various levels have different responsibilities for various parts of the process, but they interact and are interdependent in producing the final product.

Value of strategic management

Financial benefits

The principal appeal of any managerial approach is the expectation that it will lead to increased profit for the firm. This statement is especially true for a strategic management system which has a major impact both on the formulation of plans and on their implementation.

A series of studies have been undertaken involving a variety of business organizations in order to actually measure the impact which strategic management processes have had on the bottom line. One of the first major pieces of research was conducted by Ansoff, Avner, Brandenburg, Porter, and Radosevich in 1970.[4] In a study of 93 U.S. manufacturing firms, they found that formal planners who took a strategic management approach outperformed nonplanners on almost all of 21 different financial criteria, including sales, assets, sales price, earnings per share, and earnings growth. The planners were also found to be more accurate in predicting the outcomes of major strategic actions.

A second pioneering research effort was that of Thune and House in 1970,

[3] P. Lorange, *Corporate Planning: An Executive Viewpoint* (Englewood Cliffs, N.J.: Prentice-Hall, 1980), p. 62.

[4] C. W. Hofer and D. Schendel, *Strategy Formulation: Analytical Concepts* (St. Paul: West Publishing, 1978), p. 25.

who studied 36 firms in six different industries.[5] They found that formal planners in the petroleum, food, drug, steel, chemical, and machinery industries significantly outperformed nonplanners in the same fields. Additionally, they found that the planners improved their own performance significantly after their formal planning process had been adopted as compared to their financial performance during their earlier nonplanning years.

In 1972, Herold reported a replication of the part of the Thune and House study which dealt with drug and chemical companies.[6] His findings supported the earlier study and in fact suggested that the disparity between the planning and nonplanning firms' financial performance was increasing over time.

A study in 1974 of the strategic management practices of 386 companies over a three-year period conducted by Fulmer and Rue disclosed that durable goods manufacturing firms which practiced strategic management were more successful than those which did not.[7] Their findings did not hold for nondurable and service companies, probably, they suspect, because strategic planning among these firms was a recent phenomenon and its effects were perhaps not fully realized.

In 1974, Schoeffler, Buzzell, and Heany reported a study designed to measure the profit impact of market studies (PIMS).[8] This PIMS project attempted to measure the effects of strategic planning on a firm's return on investment. The researchers concluded that return on investment (ROI) was most significantly affected by market share, investment intensity, and corporate diversity. The overall PIMS model, which incorporates 37 performance variables, disclosed that up to 80 percent of the improvement that is possible in a firm's profitability is achieved through changes in the company's strategic direction.

An additional study of widespread impact was reported by Karger and Malik in 1975.[9] In their research involving 90 U.S. companies in five industries, it was found that strategic long-range planners significantly outperformed nonformal planners on generally accepted financial measures.

Finally, while most studies have examined strategic management in large firms, a project reported in 1982 found a favorable impact on performance when strategic planning was practiced in small businesses. Studying 101

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[5] S. S. Thune and R. J. House, "Where Long-Range Planning Pays Off," *Business Horizons,* August 1970, pp. 81–87.

[6] D. M. Herold, "Long-Range Planning and Organizational Performance: A Cross-Validation Study," *Academy of Management Journal,* March 1972, pp. 91–102.

[7] R. M. Fulmer and L. W. Rue, "The Practice and Profitability of Long-Range Planning," *Managerial Planning* 22 (1974): 1–7.

[8] S. Schoeffler, R. D. Buzzell, and D. F. Heany, "Impact of Strategic Planning on Profit Performance," *Harvard Business Review,* March 1974, pp. 137–45.

[9] D. W. Karger and Z. A. Malik, "Long-Range Planning and Organizational Performance," *Long-Range Planning,* December 1975, pp. 60–64.

small retail, service, and manufacturing firms over a three-year period, Robinson found a significant improvement in sales, profitability, and productivity among those businesses engaging in strategic planning when compared to firms without systematic planning activities.[10]

The overall pattern of results reported by these seven studies is one that clearly indicates the value of strategic management as gauged by a variety of financial measures.[11] Based on the evidence that is now available, organizations which undertake a strategic management approach do so with the strong and reasonable expectation that the new system will lead to improved financial performance.

Behavioral benefits[12]

The strategic management approach emphasizes a high degree of interaction by managers at all levels of the organizational hierachy in the planning and implementation process. As a result, certain behavioral consequences which characteristically accompany participative decision making also result from the strategic management process. Therefore, an accurate assessment of the impact of strategy formulation on organizational performance requires a set of nonfinancially defined evaluative criteria—measures of behavior-based effects. In fact, it can be argued that the manager who is trained to promote the positive aspects of these behavioral consequences is also well positioned to meet the financial expectations of the firm.

Regardless of the eventual profitability of particular strategic plans, several behavioral effects can be expected which should improve the welfare of the firm.

1. Strategy formulation activities should enhance the problem prevention capabilities of the firm. As a consequence of encouraging and rewarding subordinate attention to planning considerations, managers are aided in their monitoring and forecasting responsibilities by workers who are alerted to needs of strategic planning.

2. Group-based strategic decisions are most likely to reflect the best available alternatives. Better decisions can be argued as probable outcomes for two reasons. First, the generation of alternative strategies is facilitated by group interaction. Second, the screening of options is improved by contributing members of the strategizing group who can offer forecasts from their specialized perspectives.

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[10] A few additional studies, which were not discussed in the chapter, reported mixed results. However, only one piece of research has indicated that strategic management might have a negative impact. Refer to Fulmer and Rue, "Practice and Profitability of Long-Range Planning," for details.

[11] R. B. Robinson Jr., "The Importance of 'Outsiders' in Small Firm Strategic Planning," *Academy of Management Journal,* March 1982.

[12] This section was adapted in part from J. A. Pearce II and W. A. Randolph, "Improving Strategy Formulation Pedagogies by Recognizing Behavioral Aspects," *Exchange,* December 1980, with permission of the authors.

3. Employee motivation should increase as the result of a wider and more in-depth appreciation of the productivity-rewards relationships inherent in every strategic plan. Through their own participation in the strategizing process, or that of their representatives, employees come to a better understanding of the priorities and operations of the organization's reward system, thus adding incentives for their goal-directed behavior.

4. Gaps and overlaps in activities among diverse individuals and groups should be reduced as participation in strategy formulation leads to a clarification of role differentiations. The group meeting format which is characteristic of several stages of a strategy formulation process promotes an understanding of the delineations of individual and subgroup responsibilities.

5. Resistance to change should be reduced as a consequence of participating in the strategy formulation process. The required participation inherent in the process helps to eliminate the uncertainty in change which is at the root of most resistance. While participants may be no more pleased with their choices than they would be with authoritarian decisions, their acceptance of new plans is more likely when employees are aware of the parameters that limited the available options.

Behavioral costs

At the same time that involvement in a strategy formulation process creates behavior-based benefits for the participants and their firm, managers must be trained to protect against three types of unintended negative consequences. First, while it is readily recognized that the strategic management process is costly in terms of hours invested by participants, the negative effects of managers' time away from their work is less often considered. Managers must be trained to schedule their duties in a way which provides the necessary time for strategic activities but which minimizes any negative impact on operational responsibilities.

Second, if the formulators of strategy are not intimately involved in its implementation, individual responsibility for inputs to the decision process and subsequent conclusions can be escaped. Thus, it is critical that strategic managers be trained to limit their promises to performance which can be delivered by the decision makers and their subordinates.

Third, strategizing managers must be trained to anticipate, minimize, or constructively respond to the disappointments and frustrations of participating subordinates which can arise as the result of unattained expectations. Frequently, subordinates perceive an implicit guarantee that their involvement in even minor phases of the total strategy formulation process will result both in acceptance of their preferred plan and in an increase in clearly associated rewards. Alternatively, they may erroneously conclude that a strategic manager's solicitation of their input on selected issues will extend to other areas of decision making. Sensitizing managers to these issues and preparing them with effective means of negating or minimizing such negative consequences will greatly enhance the overall potential of any strategic plan.

Summary

Strategic management was defined as the set of decisions and actions resulting in the formulation and implementation of strategies designed to achieve the objectives of the organization. It was shown to involve long-term, future-oriented, complex decision making which necessitated top management action because of the extent of the resources required to accomplish an environmentally opportunistic plan.

Strategic management was presented as a three-tiered process involving corporate, business, and functional-level boards, executives, planners, and support personnel. At each progressively lower level, strategic activities were shown to be more specific, narrow, short term, and action oriented with lower risks but fewer opportunities.

The value of strategic management was demonstrated in the review of seven large-scale business research studies. Using a variety of financial performance measures, each of these studies was able to provide convincing evidence of the profitability of strategy formulation and implementation. Additionally, the chapter identified five major behavior benefits for the team-oriented, strategic management directed firm. Despite some noteworthy behavioral costs, the net behavioral gains justify the approach, almost irrespective of the hope of improved financial performance.

Questions for discussion

1. Find a recent copy of *Business Week* magazine and read the "Corporate Strategies" section. Was the main decision which was discussed strategic in nature? At what level in the organizational structure was the key decision made?
2. In what ways do you think the subject matter in this strategic management/business policy course will differ from previous courses which you have had?
3. Why do you believe that the case method is selected as the best approach for learning the skills needed in strategy formulation and implementation?
4. After graduation you are not likely to move directly into a top-level management position. In fact most members of the class may never achieve that degree of success. Why then is it important for all business majors to study the field of strategic management?
5. Do you expect that outstanding performance in this course will require a great deal of memorization? Why or why not?
6. You have undoubtably read about individuals who seemingly single-handedly have given direction to their corporations. Is it not likely that a participative strategic management approach might stifle or suppress the contributions of such individuals in a firm?

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Introduction to the Cohesion Case: Holiday Inns, Inc.

This section inaugurates a unique feature of this book, the Cohesion Case. Each of the remaining chapters will include the Cohesion Case feature.

As the word *cohesion* suggests, the objective of this feature is to "tie related parts together." Specifically, our objective is to tie together the strategic management concepts which are discussed in each chapter with an illustration of their practical application in an actual business firm. To ensure continuity across the chapters, the ten Cohesion Case sections will focus on the same company—Holiday Inns, Inc. This feature provides the added advantage of illustrating each part of the strategic management process within the same firm, thus giving you an integrated, consistent picture of the formulation and implementation of corporate strategy.

Holiday Inns, Inc., is the world's leading hospitality company with interests in hotels/motels, restaurants, transportation, and casino gaming. It was selected for the Cohesion Case feature for several reasons.

1. It is a highly visible firm which you know something about and may have patronized.
2. It is a multibusiness firm, thus allowing you the opportunity to apply strategic management concepts at three levels of strategy—corporate, business, and function.
3. While Holiday Inns, Inc., is a multibusiness firm, it is still a relatively simple, easily comprehendable enterprise. As a result, it should facilitate maximum focus on the application of text material and avoid wasted energy on simply trying to understand what the business is about.

The remainder of this section provides the case study which was written to describe Holiday Inns, Inc. This case provides the basis for understanding the remaining sections in this Cohesion Case series. You should read this case material thoroughly to gain a familiarity with Holiday Inns. As the remaining chapters (and accompanying Cohesion Case sections) are covered, you are encouraged to refer back to this case material, occasionally rereading the case. Doing this should help you understand just how the components of strategic management, discussed in each chapter, are being applied to Holiday Inns in the respective Cohesion Case sections. In addition to the case, a note on the lodging industry is provided in the case section of this book. You should read this to better understand the environment in which Holiday Inns, Inc. operates.

Your objective in this first Cohesion Case section is to become more familiar with the total operation of Holiday Inns, Inc., and to think about the relevance of strategic management to this firm. A section is provided at the conclusion of the case to aid you in applying the Chapter 1 material to Holiday Inns.

One final point: The case you are about to read covers Holiday Inns, Inc., only through early 1979. We have done this because 1979 represented a key decision point in the strategic posture of Holiday Inns. Thus, in using the Cohesion Case series, we allow you to put yourself in the role of assistant to the president and executive committee at Holiday Inns with the assignment of formulating and implementing a strategy for the 1980s. At a later point we will provide you with an update through 1981 so that you can compare your Cohesion Case analysis with recent actions at Holiday Inns.

The Cohesion Case

Holiday Inns, Inc. (A)

1 The lodging industry is a vast enterprise in the United States and Canada and overseas. In the world, for example, the 10 leading lodging firms can offer more than 900,000 rooms on any given day. Today, almost 50 percent of all lodging properties are affiliated with a chain. Some independents have developed sophisticated reservations networks in an attempt to compete with the tremendous marketing clout inherent in a chain. The largest confederation of independents united through a common reservation system is Best Western International, which represents a total of 150,000 rooms available worldwide.

2 Motels have come a long way from the days when they were a few small cabins next to the farmhouse. The AAA made an early breakthrough with a listing and rating of motels and hotels for the traveler, but it did not market its service as aggressively as some other operators.

3 If you travel and stay overnight at a hotel or motel, the chances are that you are most familiar with motels operated and/or owned by the 10 major chains in the lodging industry. The leading chains and the number of rooms each offered in 1979 are given in Exhibit 1. It is readily apparent that Holiday Inns far exceed their competition in number of rooms operated. Indeed, nightly, you can make reservations at any one of 300,000 rooms, in 1,750 Holiday Inns in 60 countries, worldwide! Quite an achievement for a company incorporated on April 30, 1954.

4 In August 1952, Kemmons Wilson opened his first hotel on the outskirts of Memphis. Wilson entered the business because he was disgruntled by the prices he was forced to pay for cramped lodging on the way to Washington, D.C., while traveling with his wife and five children.

5 From the original, Holiday Inn Hotel Courts, the determined Wilson was able to build what ultimately became the largest hotel/motel chain in the world. Growth was pursued in two primary directions: through company-owned and franchised operations. Exhibit 2 gives the distribution of the inns and rooms for the two categories.

6 Holiday Inns, Inc., growth set the pace for the lodging industry. From 1962 to 1978, Howard Johnson more than quintupled its rooms to approximately 60,000, and Ramada Inns went from 6,700 to 95,000 rooms. Since the energy crisis, Holiday Inns has continuously expanded its hotel system. Many of the company-operated hotels are operating near capacity. These

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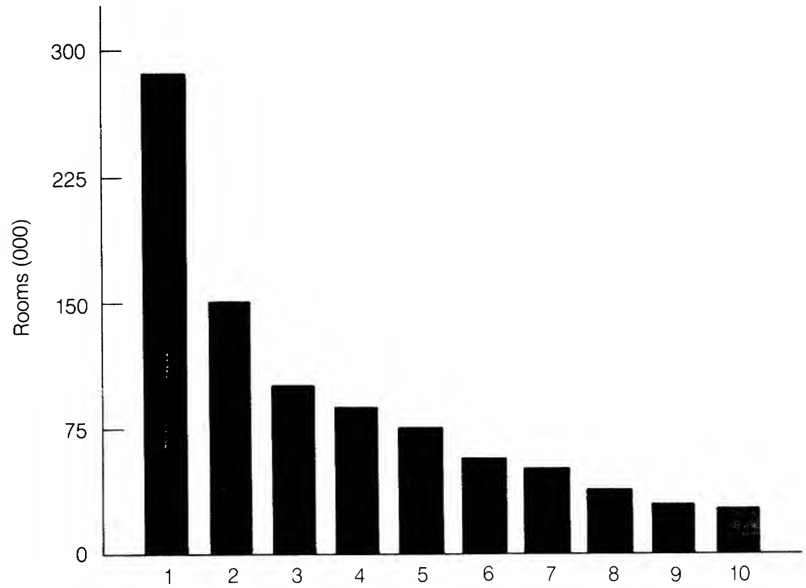
This revised edition of the Holiday Inns, Inc., case was prepared by Richard Robinson, University of South Carolina, and Tim Mescon, Arizona State University.

exhibit 1
Ten leading lodging firms



1. Holiday Inns, Inc.
2. Best Western International.
3. ITT Sheraton Corporation.
4. Ramada Inns, Inc.
5. Trust Houses Forte, Ltd. (England).
6. Hilton Hotels Corporation.
7. Howard Johnson Company.
8. Days Inns.
9. Quality Inns International, Inc.
10. Intercontinental Hotels.

Source: 1978 Service World International "100" edition.

exhibit 2
The Holiday Inns system

The Holiday Inns system, comprising both company- and licensee-operated inns, is the largest hotel business in the world. On December 31, 1977, there were 1,700 Holiday Inns facilities with a total of 278,957 rooms operated as follows:

	Inns	*Rooms*
Company operated		
Owned or leased	247	48,749
Under management contracts	24	8,035
Fifty percent owned	5	1,752
	276	58,536
Licensee operated	1,424	220,421
Total	1,700	278,957

trends and a favorable economic outlook have led the company to plan to add at least 72,000 rooms by 1983 in U.S. markets and abroad.

7 In the past, growth in the industry came (to an extent) at the expense of older hotels and nonchain motels. Hotels offer fewer rooms today than were available 10 years ago. For example, the annual rate of growth in hotel/motel rooms in the late 1960s was about 3 percent. In the latter part of the 1970s this 3 percent growth rate decreased to nearly 1 percent. The number of chain-affiliated properties has drastically increased—to the point where almost 50 percent of rooms available are controlled by the chain operations. This is projected to exceed 95 percent by 1983.

Operations of Holiday Inns, Inc.

8 When we think Holiday Inn, we generally are only considering hotels and motels. However, Holiday Inns, Inc. is a $1.2 billion per year diversified multinational corporation. In fact, only 54 percent of total corporate revenues results from hotel operations. In 1978, the company structured itself into five divisions:

1. Hotel group.
   a. Parent company.
   b. Licensees.
   c. International.
2. Products division.
   a. Inn Keepers Supply.
   b. Innkare.
   c. Dohrmann.
   d. Holiday Press.
   e. HI-Air, Holiday Industrial Park, and other minor businesses.
3. Transportation group.
   a. Trailways, Inc.
   b. Delta Steamship Lines.
4. Restaurant group.
   a. Good Company.
   b. Perkins Cake and Steak.
   c. Pipers.
5. Gaming.
   a. Atlantic City.
   b. Las Vegas.

9 As Holiday Inn moved into the decade of the 1970s, top management sought to broaden its hotel-intensive earnings base. Under the leadership of Kemmons Wilson, Holiday Inns' founder, the mission was redefined from being a food and lodging company to a travel and transportation-related company. This definition led to the five business groups and, until recently, has had Holiday Inns with over 30 unrelated business operations.

exhibit 3

Summary of income

A. The following table reflects, for the five most recent fiscal years, operating data with respect to each of the company's industry segments, together with other income, corporate expense, interest, and foreign currency translation (loss) gain.

	Amounts ($ millions)					*Percentages*				
	1978	*1977*	*1976*	*1975*	*1974*	*1978*	*1977*	*1976*	*1975*	*1974*
Revenues										
Hotel	$ 649	$ 589	$540	$526	$502	54.0%	56.9%	55.9%	57.3%	55.5%
Products	148	144	137	116	140	12.3	13.9	14.2	12.7	15.4
Transportation										
Bus	268	244	235	211	203	22.3	23.6	24.3	23.0	22.4
Steamship	155	80	81	83	78	12.9	7.7	8.4	9.0	8.6
Other	14	6	5	4	4	1.2	.6	.5	.5	.5
Elimination of products inter-segment revenues	(32)	(28)	(32)	(23)	(22)	(2.7)	(2.7)	(3.3)	(2.5)	(2.4)
Total	$1,202	$1,035	$966	$917	$905	100.0%	100.0%	100.0%	100.0%	100.0%
Income from operations before income taxes										
Hotel	$ 117	$ 90	$ 69	$ 61	$ 52	74.3%	69.1%	66.1%	60.1%	51.4%
Products	6	7	2	1	9	4.0	5.0	1.6	.9	8.9
Transportation										
Bus	20	16	15	20	26	12.6	12.6	14.7	19.7	25.3
Steamship	8	17	17	18	12	5.0	13.3	16.8	17.9	12.4
Other	8	1	2	2	3	5.1	.7	1.9	2.3	3.0
Elimination of products inter-segment income	(2)	(1)	(1)	(1)	(1)	(1.0)	(.7)	(1.1)	(.9)	(1.0)
	157	130	104	101	101	100.0%	100.0%	100.0%	100.0%	100.0%

Corporate expense	(15)	(12)	(9)	(10)	(14)
Interest, net of interest capitalized	(30)	(26)	(28)	(30)	(32)
Foreign currency translation (loss) gain	(1)	(1)	(3)	6	(9)
Total	$ 111	$ 91	$ 64	$ 67	$ 46

B. The following table reflects, for the three most recent fiscal years, identifiable assets applicable to each operating segment.

	Amounts ($ millions)			*Percentages*		
	1978	*1977*	*1976*	*1978*	*1977*	*1976*
Identifiable assets						
Hotel	$ 579.5	$ 572.4	$536.6	48.5%	55.0%	55.9%
Products	35.3	52.7	54.8	3.0	5.1	5.7
Transportation						
Bus	177.0	171.3	165.5	14.8	16.5	17.2
Steamship	215.9	163.3	148.6	18.0	15.7	15.5
Other	188.3	79.9	55.0	15.7	7.7	5.7
Total	$1,196.0	$1,039.6	$960.5	100.0%	100.0%	100.0%

10 A restructuring of the company's operations was being considered in January 1979. The thrust of the restructuring being considered was the consolidation of the products division's operations and the reorganization of this division within the hotel group. Exhibits 3 and 4 provide some insight into operations at Holiday Inns, Inc. from a management perspective as well as a reflective look at corporate financial performance through 1978. The next several sections briefly describe the operation of the five business groups that make up Holiday Inns.

The hotel group

11 Since 1976, revenues from rooms in the hotel group have increased 26 percent from $290.0 million to $364.8 million, while revenues from food and

exhibit 4
Hotel group

A. The Holiday Inns system, comprising both company- and licensee-operated hotels, is the largest hotel business in the world. On December 31, 1978, there were 1,718 Holiday Inns hotels with a total of 286,529 rooms operated as follows:

	Hotels	*Rooms*
Company operated		
Owned or leased	235	46,802
Under management contracts	30	9,941
Fifty percent owned	5	1,752
	270	58,495
Licensee operated	1,448	228,034
Total	1,718	286,529

B. The following table sets forth certain historical information concerning hotels operated by the company.

Fiscal year	*Number of hotels at year-end*	*Number of rooms at year-end*	*Occupancy rate**	*Average daily revenue per occupied room**
1978	270	58,495	74.3%	$27.81
1977	276	58,536	71.2	24.56
1976	289	58,332	68.4	22.17
1975	305	59,384	65.4	20.86
1974	309	59,898	68.3	18.38

C. The following table sets forth certain information concerning Holiday Inns hotels currently operated by licensees.

As of December 31	*Number of hotels*	*Number of rooms*
1978	1,448	228,034
1977	1,424	220,421
1976	1,424	219,732
1975	1,409	215,585
1974	1,379	207,134

beverage operations have increased 16 percent ($148.2 million to $172.0 million) during the same period.

In 1978, the Holiday Inns system increased its capacity by 7,572 rooms. Since 1975, the system has disposed of 104 hotels with 15,807 rooms. The proceeds generated from these sales were channeled into new hotels or room additions in growing markets which better reflected customer needs in that same time period—108 new Holiday Inn hotels with 19,080 rooms have opened, and another 8,287 rooms were added at existing locations where demand warranted them.

13 Hotels that are part of Holiday Inns, Inc., are segregated into two groups. The hotels in the first group are company owned, and those in the second group are licensee owned and operated. The Holiday Inns system continues to reflect the company's original emphasis on franchising. Today 80 percent of the system is operated by franchisees—independent business people or companies—while Holiday Inns, Inc., operates the remaining 20 percent. By 1978, occupancy at company-owned hotels was at a five-year high, approaching 75 percent.

14 Holiday Inns' commitment to the ownership and operation of properties provides a unique opportunity for innovation and leadership in the marketplace; for example, company-operated hotels provide an extensive research base for the development of marketing information, operating procedures, and marketing techniques. The company-operated hotels in and of themselves constitute one of the largest hotel companies in the world.

15 As shown in Exhibit 4, the number of company-owned hotels has decreased steadily since 1974. This reflects Holiday Inns emphasis on removing older properties from its system. Commenting on this trend, Roy Winegardner made the following observation:

> By 1983, 217,000 rooms on 60 percent of the Holiday Inn hotel system will be new or extensively renovated. A major emphasis for company-owned hotels will be to move into destination and multiuser properties such as airports, suburban, midtown, and downtown locations which are expected to account for over 95 percent of all company-owned or operated rooms.

Licensees

16 The 1,448 inns not operated by the company are owned by independent businesspeople called licensees. During the period 1973 to 1978, the number of inns operated by licensees increased from 1,286 to 1,448, and the number of rooms jumped from 188,973 to 228,034. For the years 1976, 1977, and 1978, respectively, licensing operations contributed $34,507,000 (4 percent), $37,933,000 (4 percent), and $47,206,000 (4 percent) in revenues for the company. The company screens all applicants for licenses carefully and places a great deal of emphasis on the character, ability, and financial responsibility of the applicant, in addition to the appropriateness of the pro-

posed location. License agreements establish standards for service and the quality of accommodations. The company trains licensee management personnel at Holiday Inn University near Memphis, Tennessee; makes inspections three times a year of licensee operations; and provides detailed operational manuals, training films, and instructional aids for licensee personnel. During the initial period of 20 years, most licenses may be terminated in certain circumstances by the licensee. In the event of a licensee's violation of the agreement, the company may terminate the license. The company's policy in determining whether or not to renew a particular license agreement is in part to evaluate the overall desirability of retaining the licensee's inn within the system. During 1977, the initial 20-year term expired on five licenses, of which two were renewed.

17 The fees required by newly issued or renewed franchise agreements have been increased from time to time. New or renewed domestic license agreements in 1978 consisted of

1. An initial payment of $5,000.
2. A fee of $150 per room (minimum $20,000).
3. A royalty of 4 percent of gross room sales.
4. Conversion of 2 percent of gross room sales for marketing and reservation services.

18 **The legal status of the licensee agreement.**[1] The Holiday Inns licensee agreement has been challenged in recent court actions by an increasing number of licensees (franchisees). The agreement is being challenged on two basic points:

1. Violations of antitrust laws.
2. Fiduciary duties to present licensees regarding future locations of Holiday Inns properties.

19 Litigation is still pending which involves a class action suit by 412 licensees that challenges Holiday Inns right to enter into license agreements with third parties without giving a first option to established licensees for the operation of a Holiday Inn facility in the same local area where a licensee's Holiday Inn facility exists. This same litigation asks for damages against Holiday Inns, Inc., by virtue of its license agreement prohibiting Holiday Inn licensees from owning interests in inns, hotels, and motels other than Holiday Inn facilities. This latter issue is challenged as a violation of several sections of the Sherman Antitrust Act, including restraint of trade and unlawful interstate commerce.

[1] In addition to challenges to the basic franchise agreement, numerous franchises have raised objections to the quasi requirement that they buy all furniture, equipment, and supplies through the products group businesses when similar items are available elsewhere at lower costs. This is particularly intense during additions, renovations, and construction of additional properties when Holiday Inns' pre-opening quality inspections try to, among other things, promote the maintenance of high standards in furnishings and equipment while the franchise is trying to reduce initial capital investment.

20 One franchisee, American Motor Inns, Inc. was awarded $4 million in damages from Holiday Inns on the antitrust issue involving a licensee's right to have non-Holiday Inn facilities. This verdict is still under appeal by Holiday Inns. In 1978, a licensee of three Holiday Inn facilities in Mobile, Alabama, was awarded a verdict in excess of $1 million by a jury only to have the verdict set aside by the court. The right to own non-Holiday Inn facilities was at issue, and the decision is being appealed. Another case, initiated in late 1976, is asking $25 million in damages based on Holiday Inns's granting a Holiday Inn franchise in Elizabeth, New Jersey. It is claimed that this franchise hurts an existing operation at the Newark Airport in New Jersey.

21 Additionally, in 1978, the Domed Stadium Hotel, Inc., a licensee of the company (located in New Orleans), filed suit against Holiday Inns, Inc., hoping to enjoin the parent company from acquiring a competing hotel, The Chateau Lemayne, in New Orleans. In January 1979 an affiliate of the Domed Stadium Hotel, Inc., filed suit in Mississippi alleging that the company (Holiday Inns, Inc.) made misrepresentations and fradulently induced the plaintiff to invest in a motel in Pearl River County, Mississippi. The plaintiff is seeking $550,000 in actual damages and $1 million for punitive damages.

International operations

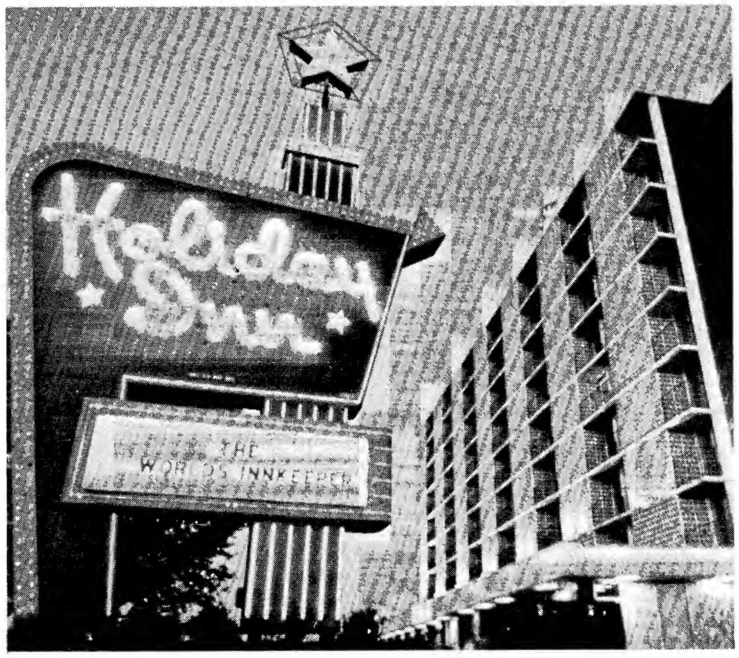
22 Foreseeing possible obstacles in the intensive expansion of hotels/motels in the United States, Holiday Inns, Inc. has been rapidly expanding hotel operations abroad. The company's international development strategy is to build strong national chains within the countries where it now operates, as well as to gradually expand into new markets. Holiday Inns, Inc., argues that this strategy differs from that of its competitors who have but one location in each major city overseas.

23 By the end of 1978, international locations (55 countries) accounted for 195 existing hotels (of which 161 were licensed) and 20 under construction (of which 11 will be licensed) with well over 40,000 rooms. The company reported operating gains in its international operations in 1977 and 1978 compared with losses in previous years. Gains were attributed to higher levels of occupancy, higher average room rates, and increased operating efficiencies. Political difficulties in Lebanon in 1975 forced the closing of a company-leased hotel in September of that year.

Holiday reservation system

24 Holiday Inns operates the Holidex reservation system, which links over 17,000 terminals throughout the world, thus representing the largest reservation system in the hotel industry. The company is devoting considerable resources to creating the second generation of this system. Holidex II will not only be an information system, providing accounting and room inventory

exhibit 5
Holiday Inn motels are familiar to highway travelers



services, but will also provide a marketing data base as well as informational services at the unit location by 1980. Holiday Inn is investing over $20 million in the development and installation of Holidex II.

25 The importance of a reservation system such as the Holidex network cannot be overstated. Through 1978, approximately 70 percent of all room-nights at Holiday Inns were sold through advance reservations. As the industry becomes more competitive, the Holidex reservation system, along with its management information capacity, will be of even greater importance.

Quality control

26 Regular on-site inspection is a major way hotel group management tries to ensure that the Holiday Inn hotel system offers the traveling public a consistently superior "no-surprise" accommodation value. Twenty-five full-time inspectors traveled more than 1 million miles during 1978 performing some 4,300 property reviews. Most properties are inspected three times a year on an unannounced basis during which some 1,100 different items are checked. Those properties which fall below set standards are revisited and programs are initiated to correct shortcomings. Hotels that fail to pass a follow-up

inspection are removed from the system. Several units were removed from the system during 1978 because of failure to meet these standards.

27 A second quality control measure is the guest inspection program. Prepaid postcards are placed in each guest room inviting comments on service and property conditions. Tabulated by a central computer, the cards give Holiday Inn executives a grass-roots response from the ultimate inspector.

28 Commenting on the importance of quality control, Eric Bernard (1978 hotel group president) explained:

> Market research studies indicate that 70 percent of the guests at a hotel have never previously stayed at that particular location. Their decision to stay there is based on the brand-name reputation, an image which may have been formed by a prior experience with that particular chain or by the recommendation of a friend. It is essential that the company maintain high systemwide dependability in quality.

Products division

29 The products division distributes institutional furnishings, equipment, expendable supplies, and printed products to the lodging, housing, health care, and food service markets. The principal functional groups within the division are:

1. Inn Keepers Supply (IKS)—IKS accounted for 60 percent of the division's competitive sales in 1978. Distributing furnishings and equipment to the food, lodging, and health care industries is IKS's principal business. IKS sells its products through 77 salespeople nationwide and four product display centers located across the country. The division has recently expanded operations in Great Britain, agreeing to sell furnishings and equipment to the Grand Metropolitan Hotels.
2. Dohrmann—This unit accounted for almost 16 percent of the division's competitive sales in 1978. Dohrmann, building its reputation for tabletop items, now carries over 5,000 products and operates in 10 western states through 80 sales representatives. Dohrmann is the only in-house distributor owned by the company.
3. Innkare—Offering a range of over 4,000 items, including cleaning chemicals, kitchen utensils, and maid supplies, this unit accounted for almost 15 percent of the division's sales in 1978. Operating as a master distributor, the Innkare organization sells to 55 independent distributors nationwide, who sell Innkare products to more than 100,000 motels.

30 These three functional groups account for over 80 percent of competitive sales. Half of the remaining sales are generated through a printing operation: Holiday Press. Two smaller operations—HI-Air, a fixed base aircraft dealer, and Holiday industrial park, a commerical land development project—accounted for the remaining sales.

31 The product group has undergone rapid change in the past three years. The group discontinued its manufacturing operations, and recently phased

out its construction operation. These operations were eliminated because they no longer fit with the longer-term strategy of this group. This strategy is designed to narrow the base of its operations by disposing of properties not directly related to services in the lodging, entertainment, and food service industries. During 1978, Holiday disposed of two additional operations formerly a part of the products group.[2] These dispositions reduced the number of major operating units within the group to the three discussed above, streamlined from 26 units in 1974.

32 Revenues reached $144 million in 1977, a 5 percent increase from 1976. Competitive revenues, after eliminating sales to company-owned facilities, were $115 million, increasing 10 percent over 1976. The more rapid increase in competitive sales reflects the group's penetration of new outside markets (90 percent franchises).

33 Operating income increased by $5 million to $7 million in 1977, but fell slightly in 1978. Operating income in 1976 included losses of $2 million in connection with phasing out construction activities. Specific financial performance data for this division is provided in Exhibit 6.

exhibit 6
Products division financial performance data ($ millions)

	1978	*1977*	*1976*
IKS	$ 89.0	$ 75.3	$ 70.1
Innkare	21.8	19.4	16.8
Dohrmann	23.6	23.8	22.3
Other	13.7	25.1	28.0
Total revenue	$148.1	$143.6	$137.2
Operating income	$ 6.2	$ 6.6	$ 1.7
Operating margin	4.2%	4.6%	1.2%
Capital expenditures	$ 0.8	$ 0.7	$ 0.6
Assets	35.3	52.7	54.8

34 The products group operates on a small fixed-asset base and requires little capital investment. As sales and operating performance continue to improve, this group is expected to contribute a high return on investment, which is consistent with the corporate strategy to raise the overall return on investment.

Transportation group

35 The transportation division of Holiday Inns, Inc., consists of two major units: Trailways (headquartered in Dallas, Texas), the second-largest intercity bus system, and Delta Steamship Lines. By 1978, the transportation division accounted for 35 percent of Holiday Inns, Inc. revenue, with bus operations producing 22 percent and steamship operations producing 13 percent (see Exhibits 7 and 8).

[2] Holiday Press and HI-Air.

exhibit 7

Transportation group: Bus operations

A. Bus operating statistics

	Fiscal years				
	1978	*1977*	*1976*	*1975*	*1974*
Bus operating revenues (000)	$ 254,495	$ 240,262	$ 226,568	$ 204,421	$ 195,058
Bus miles (000)	190,770	198,125	207,678	196,682	198,628
Number of intercity buses	2,158	2,203	2,312	2,405	2,271
Passenger miles (000)	2,694,454	2,856,095	2,727,453	2,675,238	2,871,526
Bus occupancy (load factor)	39.5%	40.4%	36.4%	36.6%	39.5%

B. Bus operations—financial performance ($ millions)

	1978	*1977*	*1976*
Passenger	$145.7	$141.9	$136.8
Charter	44.7	41.2	38.9
Express	58.8	51.3	44.9
Other	18.9	10.0	14.1
Total revenue	$268.1	$244.4	$234.7
Operating income	$ 19.7	$ 16.4	$ 15.4
Operating margin	7.4%	6.7%	6.5%
Capital expenditures	$ 21.4	$ 10.0	$ 13.1
Assets	177.0	171.3	165.5

exhibit 8
Transportation group: Steamship operations

A. Steamship operating statistics

	1978	*1977*	*1976*	*1975*	*1974*
Tons of cargo	1,190,552	636,852	727,201	733,583	930,439
Completed voyages	97	45	51	62	60

B. Steamship operations—financial performance ($ millions)

	1978	*1977*	*1976*
Revenue	$155.0	$ 80.1	$ 81.1
Operating income	7.8	17.3	17.6
Operating margin (in percent)	5.0%	21.6%	21.7%
Capital expenditures	48.8	24.2	0.2
Assets	215.9	163.3	148.6

36 The Trailways route system covers 70,000 miles—5,000 cities and towns in 43 states—and provides package express and charter service throughout most of the United States.

37 J. Kevin Murphy, formerly president of Purolater Services, Inc. was named president of the bus operations in 1977. Placing primary emphasis on new marketing approaches, Murphy streamlined the company's name, Continental Trailways to Trailways and adopted a sunburst logo. A new marketing program called the Anywhere Program was initiated. It allowed the traveler to go anywhere in the United States—from one origin city to a destination city—with unlimited stopovers for a low, fixed price. Advertising expenditures were increased in 1977 on programs stressing the cost-saving aspects of bus travel as opposed to other transportation forms. During 1978, Trailways completed a $4 million terminal of the future in Houston, Texas. And as a result of a movement toward energy efficiency, the company installed speed governors on its buses which limit the maximum speed to 55 miles per hour.

38 Trailways in 1978 became the first intercity bus company to offer a discount to senior citizens, a group which makes up 25 percent of its market. The idea was initiated as a result of a recommendation from Trailways' senior citizen advisory council. Holiday Inns corporate executives anticipated that Trailways' senior citizen and charter passengers would provide a convenient customer base for its hotel properties.

39 Two growing segments of bus services are charter operations and package express. Trailways's charter operations serve 26 million passengers a year, representing 9 percent of the total charter market. During the previous five-year period charter sales have grown at a compounded annual rate of almost 13 percent.

40 Package express, the fastest-growing segment of the Trailways division

accounts for 22 percent of total revenues from bus operations. Package pickup and delivery is offered in more than 110 major U.S. cities.

41 Delta Steamship Lines operates a fleet of 24 vessels between Gulf ports, Central America, South America, and Africa. Though revenues were affected by a 59-day work stoppage by longshoremen in 1977, they remained approximately the same as in 1976, but they increased dramatically in 1978. In 1973, Delta introduced LASH (light aboard ship) cargo containers in its operations. The LASH containers (there are found in all) are filled before the arrival of a ship to improve the scheduling of the ship's time in port. For example, the average length of a typical South American voyage has been reduced from 84 to 42 days by using LASH containers.

42 In June 1978, Delta reached an agreement with Prudential Lines, Inc., to acquire 13 vessels and add five new trade routes (from the East and West Coasts of the United States) over the next two years at a cost in excess of $71.5 million. Approximately half of the Prudential acquisition cost will be financed using Delta's capital construction fund, and the balance will come by Delta assuming low-interest, government-guaranteed mortgages on the vessels.

43 The Prudential acquisition returned Delta to passenger service, an area in which the line had no involvement since 1968. All four combination passenger/cargo vessels acquired from Prudential have first-class accommodations for 100 passengers.

44 But of greater importance to Holiday Inns' steamship operation, the acquisition doubled the number of Delta's Latin and South American trade routes to Pacific U.S. ports.

45 While Delta's revenue nearly doubled in 1978, operating income dropped significantly. Captain J. W. Clark, president of the Delta operation, offered the following reasons:

> For one thing it took longer to absorb the Prudential Lines, Inc. operations than originally thought. This was due to start-up costs connected with the acquisition, the transfer of vessels to new routes, higher-than-anticipated maintenance costs required to bring the new fleet up to Delta standards, and a delay in closing the transaction which reduced the revenue base over which expenses could be spread. Unsettled political and economic conditions also affected Delta's West Africa Trade.

46 Though faced with heavy foreign competition, Delta, the major U.S.-flag cargo carrier in its trade routes, anticipated increased market share through effective vessel scheduling, LASH technology, and beneficial government subsidizes of U.S. marine transport operations.[3]

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[3] Delta operates under an operating differential subsidy agreement in which the U.S. government compensates Delta for portions of certain vessel operating expenses that are in excess of those incurred by its foreign competitors. The subsidy recorded in 1978 and 1977 amounted to $33,666,000 and $15,035,000, respectively.

Restaurant group

47 On April 18, 1979, Holiday Inns, Inc. announced that it had signed a formal purchase agreement to acquire Perkins Cake and Steak, Inc., a privately held restaurant chain headquartered in Minneapolis. Perkins has approximately 80 company-owned and 270 franchised restaurants in some 30 states concentrated in the Midwest. Revenues for the company, for the fiscal year ending March 3, 1979, were $71 million, with system-wide sales of $200 million.

48 The decision to enter the freestanding restaurant business reflects significant research on consumer trends, as well as a corporate desire to build a broader earnings base. One of the unique characteristics of the food-away-from-home market is its ability to maintain margins and revenues during both recessionary and inflationary periods. Penetrating this market will come through acquiring existing companies, as well as by developing new restaurant concepts. One grass-roots development is a new restaurant called Good Company, featuring a moderately priced menu and entertainment. The company plans to open a second test unit in Dallas in the latter part of 1979.

49 With an ever-increasing portion of the family food budget spent on meals away from home, Holiday Inns, Inc., entered the freestanding restaurant business seeking a growth industry in which to broaden its earnings base.

50 Changing American demographics support continued restaurant industry growth. The nation has significantly more single-member households and smaller family units which have higher discretionary incomes. And, food away from home is increasingly viewed as a necessary convenience.

51 Based on this growth potential, Holiday Inns purchased Perkins Cake and Steak, Inc., a family-oriented restaurant chain, for 2 million shares of common stock.

52 Perkins was founded 21 years ago and today consists of 94 company-owned and operated and 270 franchised units, with 1979 system-wide sales of approximately $240 million. From 1972 to 1978, the company has grown from the 136th largest food service company to the 63d largest according to *Institutions* magazine. Mature, company-owned restaurants average nearly $1 million in annual sales. The accompanying table provides historical performance data on the Perkins' chain.

table 1
Perkins historical data ($ millions)

	*1979**	*1978*	*1977*	*1976*	*1975*
Revenues	$81.8	$67.8	$47.0	$35.5	$17.5
Operating profit	10.1	6.8	4.0	2.8	1.5
Number of stores:					
Corporate units	94	71	56	48	36
Franchise units	270	270	260	252	220
Total units	364	341	316	300	256

*Estimated.

53 Based on prepurchase market research, two thirds of Perkins' customers were found to be between the ages of 18 and 49 and have annual household incomes in excess of $15,000. Demographically, the Perkins customer profile is similar in many respects to that of a Holiday Inn hotel guest.

54 Perkins is positioned in the marketplace as a family restaurant. It offers a broad menu at moderate prices and table service in pleasant surroundings. Most are open 24 hours a day. A typical Perkins restaurant built within the past three years seats 172 people in a 5,000-square-foot structure. About one third of the restaurants in the Perkins system are less than four years old.

55 Franchised restaurants have been, and are expected to continue to be a major vehicle for expansion. There were 270 franchise units at the close of 1979 with 23 new units opened during the year.

56 Perkins is selective in its franchising program. Ownership of Perkins' franchise units is widespread with no licensee having more than 20 units—only two have more than 10.

57 Perkins's unit growth has been substantial. The system has grown from 256 units in 1975 to 364 in 1979. During this period, company-owned restaurants grew from 36 to 94 units. In 1979, 23 new company-owned units were added. The system is programmed to expand by 15 to 20 company-owned units and a similar number of franchised properties in 1980. Growth is expected to continue at a slightly increased rate over the next two to three years. New units will complement existing areas of operation, providing economies of scale, while strengthening market position.

Gaming group

58 In September 1978, the board of directors of Holiday Inns, Inc., announced that it had expanded corporate policy to explore potential opportunities for hotel/casino operations in any area where such operations are legal. While the company stressed that this decision implied no firm commitment toward a new development, it did indeed recognize the fact that the expansion in this area represents a natural extension of its current hotel operations. Previously, corporate policy restricted the expansion of hotel/casino operations to the state of Nevada and areas external to the United States.

59 Just two weeks following this announcement, the company approved a proposal to construct and manage a $75 million hotel/casino in Atlantic City, New Jersey. The hotel/casino will be a joint venture between Holiday Inns, Inc., and a Los Angeles-based developer (who happens to own the property on which the hotel is to be built). When it is completed it will include 500 rooms and a 50,000-square-foot casino.

60 In April 1979, Holiday Inns, Inc. announced that it would acquire a 40 percent interest in Riverboat, Inc., a casino operated in conjunction with the Holiday Inn–Center Strip Hotel in Las Vegas, Nevada. For the fiscal year ended June 1978, Riverboat, Inc. had revenues of $36.3 million and a

pretax income of $8.8 million. For the six months ended December 31, 1978, Riverboat revenues were $20.1 million and pretax income, $5.7 million.

61 The entry of Holiday Inns, Inc. into the casino/hotel business was the culmination of a thoroughly researched and planned effort which included almost five years of conducting and analyzing detailed feasibility studies and holding discussions with authorities and state officials in both Nevada and New Jersey.

62 Gaming was one industry that was examined when the company began researching future growth opportunities in the hospitality industry in 1975. Initial investigation revealed that most successful casino operations include hotels, a business in which the company was an acknowledged leader. Casinos also have sizable food and beverage operations, an area where the Holiday Inn system averages more than $1 billion in annual revenues. Preliminary studies also indicated that the Holiday Inn hotel customer exhibited demographic characteristics similar to those of gaming participants (see the accompanying table).

Demographic comparison

	Las Vegas casino visitor	*Holiday Inn guest*
Age 21–50	66%	66%
Family income: over $15,000	73	69
Occupation: professional, manager, white-collar	40	37

63 Holiday Inns' research showed that 80 percent of adults approve of gambling and 60 percent participate in some form, ranging from casino visits to fund-raising raffles. Their conclusion: gaming is truly a national pastime and is viewed by the public as a leisure activity. Of the 11 million people who visited Las Vegas in 1978, the average guest spent about $200 in nongaming expenditures with $300 budgeted for gaming.

64 Traditionally thought of as the exclusive domain of Nevada, the opening of Atlantic City to casino operations has given gaming a whole new outlook, and casino revenues are expected to more than double to $5–$7.5 billion nationwide by 1985.

65 Holiday Inns' extensive research led to the conclusion that it "needed outside expertise in gaming and big-name entertainment contracting. Careful control of the large volumes of cash handled requires well-run operations and specialized procedures. Thus, if we (Holiday Inns) were to succeed, we would need seasoned management in place."

66 Of the conclusions drawn from this research, the one which most influenced the company's decision to enter the hotel/casino business was threefold: (1) that the overwhelming majority of Holiday Inn guests had no objection to the company's becoming involved in the gaming business,

(2) that the hotel/casino industry offers a natural extension of the company's main line of business, and (3) that investment in this industry would produce substantial returns.

67 This decision, however, was reached over considerable internal management dissention. Several key managers questioned the inappropriateness of gambling relative to the founding philosophy and mission of Holiday Inns. As evidence of the degree of top-management polarity, this decision triggered the resignation of the company president and chief executive officer, L. M. Clymer. Clymer said that his resignation was incited by personal and religious opposition to this company decision. In a company-released statement, Clymer defended his decision with the following comment:

> This is a personal conviction not involving the financial or business aspect of the industry. The great concern in my heart is that some may erroneously read into this action a silent judgment of those who have reached a different conclusion; this most certainly isn't the case.

68 Several observers questioned the ability of Holiday Inns to move rapidly into gaming if traditional Holiday Inn managers were hesitant to accept this new entity. Some observers, such as Best Western's President Robert Hazard, questioned the move as "infatuation that could burst like a bubble."

Holiday Inns, Inc. management team

69 Many people have made invaluable contributions to Holiday Inns, Inc., through the years. Today the Holiday Inns, Inc., hotel system employs about 150,000 people. Their supportive efforts helped the Holiday Inns, Inc., hotel system exceed $3 billion in revenues in 1978.

70 Kemmons Wilson, now chairman of the board, recognized in 1951 that the lodging industry was "the greatest untouched industry in the world."

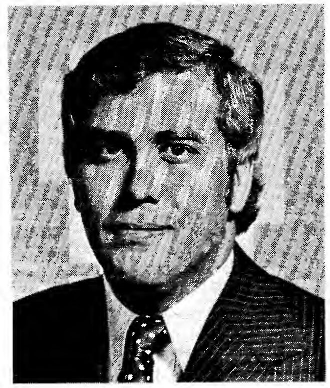
71 As the business grew, William B. Walton, a young attorney and a graduate of Memphis State, became the company's executive vice president and chief administrator. Walton, later president and now vice chairman, was the architect of the company's licensing systems.

72 In 1957, L. M. Clymer, a Duke graduate and an investment banker with W. H. Morton & Co., was named to the company's board of directors. He contributed to the firm's financial progress and joined Holiday Inns, Inc., as a senior vice president in 1968. Clymer was named president in 1973 and in 1976 assumed the additional responsibilities of the chief executive officer. Clymer resigned in 1978.

73 In 1974, Roy E. Winegardner, a licensee who had one of the company's earliest and largest hotels, joined Holiday Inns, Inc., as first vice chairman. In 1977, Winegardner was appointed chief operating officer of Holiday Inns and in January of 1979, he became president and chief executive officer of the company. (See Exhibit 9.)

exhibit 9

A. Roy E. Winegardner



B. Michael D. Rose

C. Richard J. Goeglein

D. Eric Bernard

74 Michael D. Rose had worked with Winegardner for many years and in 1976 joined the company as president of the hotel group.

75 In September of 1978, Richard J. Goeglein, formerly a vice president of the R. Grace & Company, joined Holiday Inns, Inc., as a corporate executive vice president.

76 With Clymer's resignation in the latter part of 1978, Winegardner (who had previously shared the recently established office of the president with Clymer) became president and chief executive officer of the company. Joining him in the office of the president are Goeglein (who, while an executive vice president at W. R. Grace & Company, thwarted every restaurant acquisition attempted by Holiday Inns, Inc.) and Michael D. Rose, who is both a lawyer and an accountant.

77 In 1976 the company began to restructure the composition of its board of directors and elected four outside members. At the annual meeting that year,

the shareholders voted to reduce board membership from 21 to 15. Today, the board includes six inside members and nine outside members.

78 The board of directors includes the following persons:

Wallace R. Bunn, 56, president and chief executive officer of South Central Bell Telephone Company, which provides telecommunication service. Prior to 1978, he was president and chief executive officer of Pacific Northwest Bell Telephone Company. He is presently a director of First National Bank of Birmingham.

William N. Clarke, 61, partner in the law firm of Cadwalader, Wickersham & Taft, New York, New York.

Frederick G. Currey, 46, president of the company's transportation group.

W. M. Elmer, 63, chairman of the board of Texas Gas Transmission Corporation, which is involved in transportation and gas services. Prior to May 1978, he was also chief executive officer of Texas Gas Transmission Corporation.

Nicholas M. Evans, 48, president of the Drackett Co., which manufactures and markets household products and specialty foods. In addition he is vice president of the Bristol-Myers Co. and director of Ohio National Life Insurance Co.

Richard J. Goeglein, 44, executive vice president of the company. Prior thereto, he was vice president of W. R. Grace & Company and executive vice president of its consumer services group.

Richard A. Jay, 60, vice chairman and director of the Goodyear Tire & Rubber Co., which manufactures and distributes tires and other products. He is also a director of Texas Gas Transmission Corporation.

Herbert S. Landsman, 60, executive vice president and director of Federated Department Stores, Inc., a department store group. He is also a director of Clopay Corporation.

R. A. Lile, 70, president and chief executive officer of Transportation Properties, Inc., Little Rock, Arkansas, a real estate and investment firm. He is also a director of National Old Line Insurance Company.

Archibald McClure, 56, executive vice president of the Quaker Oats Co., which manufactures and markets consumer products and specialty chemicals. He is also a director of the Wilmette Bank.

Allen B. Morgan, Sr., 70, honorary chairman of the board of First Tennessee Bank, N. A., Memphis, Tennessee, a multibank holding company.

Michael D. Rose, 37, executive vice president of the company. Prior to his election as executive vice president, he was president of the company's hotel group and inn development division.

William B. Walton, 59, vice chairman of the board of the company.

Kemmons Wilson, 66, chairman of the board of the company, a control person.

Roy E. Winegardner, 58, president and chief executive officer of the company, a control person.

Marketing efforts

79 In mid-1977, Holiday Inns initiated an aggressive advertising campaign to complement the very successful "The best surprise is no surprise" theme, which emphasized motel quality and dependability. The new campaign slogan is "Holiday Inn welcomes you to some of the best hotels in the world." Basically, the campaign was premised on three "facts": that the Holiday Inns system has the best location, that the company has the best system of standards, and that a Holiday Inn is the first choice of most travelers over any other hotel. To convey this message, the company has utilized prime-time television spots in addition to advertising in major national publications. The marketing effort emphasizes that preference for the Holiday Inns system is increasing. A recent survey indicates that almost half of the traveling public selects Holiday Inns motels as their first choice in lodging.

80 In addition to company advertising efforts, Holiday Inns has been working to alleviate a frequent consumer complaint: overbooking. In October 1977, the company initiated the "We guarantee it" program. This program not only assured the customer of a firm reservation but also improved flexibility in scheduling room demand. The program was the industry's first major attempt to curb the problems of no-shows and diminish the overbooking rate. By the end of 1978, the company estimated that systemwide no-shows declined by more than 40 percent, accounting for a savings in lost revenue in $31 million.

81 The major theme developed by the company for 1978 described Holiday Inns hotels as "people pleasin' places." It stressed locations and standards.

82 Company research indicates that one third of the lodging customers purchase 70 percent of the rooms. Holiday Inns continued to recognize the importance of these customers by maintaining the Inner Circle program for its most frequent travelers.

83 During recent years the company has redirected its sales efforts, changing its emphasis from sales in destination markets to locating its sales offices in cities where trips originate. This new concept, called outbound sales, evolved from a better understanding of customer travel decisions.

84 In 1978, in an effort to combat discount fares offered by airlines on selected routes, the Trailways division announced a new series of low fares between major cities in the northeastern section of the United States. In addition to the airlines, Trailways was trying to counteract Greyhound's 1978 discount offerings on interstate routes. These fares represent a reduction of 30 to 50 percent from regular fares and apply to selected schedules. Additionally, the company announced that it planned to offer a $59 fare on

one-way trips averaging 775 miles or more. (Round-trip fares are double the one-way fares.) Trailways noted that the new low fares, which have received ICC approval, apply only to interstate travel.

85 Touting three major themes—price, cheaper than Greyhound, and senior citizens—Trailways, in 1978, advertised 193 times on network television and produced 3,952 radio and television advertising spots in 125 cities nationwide.

Employee relations

86 Holiday Inns has outlined five basic principles that form corporate philosophy. These are:

1. Maintain high ethical standards.
2. Provide above-average growth in earnings.
3. Improve our return on invested capital (ROIC).
4. Maintain a strong balance sheet through financial management.
5. Realize people are our greatest asset, deserving careful selection, training, and motivation.

Fulfilling the fifth tenet is no easy task when over 36,000 employees are involved. Labor relations with corporate employees, excluding the 10,000 in the transportation group, have been good.

87 Management-employee relations in the transportation group (which also includes as many as 2,500 longshoreworkers employed on an hourly basis) have been satisfactory. However, there have been several disputes and work stoppages during the past six years, including one lengthy strike at a Trailways subsidiary from 1972 to 1976 and an 18-day work stoppage at five southeastern operating companies during 1976. Since that time, however, there have been no significant problems. In 1979, the company entered into 19 labor contracts covering 2,622 employees. Forty percent of all employees at Holiday Inns, Inc. are unionized.

Financial performance

88 Exhibit 10 provides a 10-year summary of the financial performance of Holiday Inns, Inc. Revenues for the year 1978 achieved new record levels. Revenues increased by \$167 million—7.2 percent—in 1977. Pretax income increased by \$20 million—22.4 percent—during 1978 and \$27 million—41.4 percent—during 1977. Of particular interest is the increase evident in the transportation division. Since 1974, revenues from this operation have increased by 32.2 percent, and revenues from steamship operations have increased by 99.1 percent. The major force in this increase was the Prudential acquisition, and indeed between 1977 and 1978 steamship revenues increased by 93.5 percent. An analysis of the company's 10-year performance

exhibit 10
Ten-year financial performance

	1978	1977	1976	1975	1974
Operating results ($ millions)					
Revenues	$ 1,202.2	$ 1,035.3	$ 965.6	$ 917.0	$ 905.1
Operating income	156.8	130.3	104.7	101.3	101.1
Income before income taxes—continuing	111.1	90.8	64.2	67.2	46.4
Income taxes—continuing	48.3	38.1	24.9	26.2	20.4
Net income—discontinued	—	—	(.4)	.5	.9
Net income	62.8	52.7	38.8	41.5	26.9
Common stock data					
Earnings per share	2.04	1.71	1.27	1.35	.87
Dividends declared per share	.56	.465	.40	.35	.325
Average number of shares outstanding (000)	30,854	30,762	30,657	30,606	30,802
Financial position ($ millions)					
Total assets	$1,196.0	$1,039.6	$ 960.5	$ 957.0	$ 973.5
Property and equipment (net)	767.1	705.0	679.4	692.4	720.1
Long-term debts	322.2	310.2	299.4	332.5	372.7
Stockholders' equity	552.4	504.8	465.8	438.6	408.6
Depreciation and amortization	63.1	58.9	56.5	57.1	59.5
Capital expenditures	169.1	112.1	70.2	59.5	86.2
Performance measurements (in percent)					
Return on sales	5.2%	5.1%	4.0%	4.5%	3.0%
Return on invested capital	8.5	7.8	6.4	6.8	5.2
Return on equity	11.9	10.9	8.6	9.8	6.7
Statistical summary					
Number of inns at year-end					
Company operated	270	276	289	305	309
Licensee operated	1448	1424	1424	1409	1379
Total system	1718	1700	1713	1714	1688
Number of rooms at year end					
Company-operated	58,495	58,536	58,332	59,384	59,898
Licensee-operated	228,034	220,421	219,732	215,585	207,134
Total system	286,529	278,957	278,064	274,969	267,032
Occupancy (in percent)	74.3%	71.2%	68.4%	65.4%	68.3%
Average rate per occupied room	$27.81	$24.56	$22.17	$20.86	$18.38
Passenger miles (millions)	2,694.5	2,856.1	2,727.5	2,675.2	2,871.5
Load factor (in percent)	39.5%	40.4%	36.4%	36.6%	39.5%
Voyages completed	97	45	51	62	60
Tonnage carried (000)	1,190.6	636.9	727.2	733.6	930.4

5-year compound growth rate	*1973*	*1972*	*1971*	*1970*	*1969*	*10-year compound growth rate*
7.4%	$ 808.8	$ 718.2	$ 661.8	$ 557.3	$ 489.4	10.5%
11.6	106.6	102.5	97.5	88.6	79.4	7.8
24.4	63.1	74.4	67.7	62.4	57.4	7.6
24.0	23.9	34.0	31.2	27.1	26.5	6.9
—	2.0	1.4	1.5	1.1	.9	—
23.6	41.2	41.8	37.9	36.4	31.8	7.9
23.8	1.32	1.37	1.32	1.29	1.18	6.3
14.6	.30	.275	.25	.225	.20	12.1
—	31,055	30,532	29,846	28,525	27,950	1.1
5.3	931.9	892.6	794.9	708.7	607.7	7.8
1.2	706.8	633.5	566.6	500.9	444.1	6.3
(3.6)	381.9	381.3	324.1	324.0	257.0	2.5
7.8	395.7	365.6	328.6	251.7	209.8	11.4
1.5	48.9	43.1	38.9	34.3	31.3	8.1
18.4	127.2	112.4	121.7	93.8	89.0	7.4
14.7	5.1%	5.8%	5.7%	6.5%	6.5%	(2.5)
13.1	6.8	7.1	7.5	8.3	8.6	(0.1)
15.4	10.8	15.2	13.1	15.8	16.1	(3.3)
(3.3)	305	297	290	287	265	0.2
1.2	1286	1173	1081	984	899	5.4
0.4	1591	1470	1371	1271	1164	4.4
(0.6)	57,940	54,643	51,687	49,109	42,559	7.3
2.4	188,973	166,470	148,777	130,255	116,328	6.6
1.8	246,913	221,113	200,464	179,364	158,887	6.8
2.1	70.6%	70.7%	67.4%	68.5%	72.3%	0.3
10.9	$17.63	$16.87	$16.50	$15.55	$14.11	7.8
(1.6)	2,627.2	2,486.5	2,899.1	2,845.7	2,603.1	0.4
—	37.1%	36.0%	39.2%	39.8%	38.4%	0.3
12.8	45	40	58	48	45	8.9
6.4	701.9	483.4	661.0	584.3	436.7	11.9

shows that the only visible significant drop in income occurred between the years 1973 and 1974, during the peak of the OPEC oil embargo.

89 In October 1978, Stafford-Lowden, Inc., announced that it had agreed to purchase the assets of the Holiday Press division of Holiday Inns, Inc. The printing operation, accounting for 10 percent of the products division sales in 1977, is a 300,000-square-foot facility located in Olive Branch, Mississippi. Its primary activities involve providing business forms and web-press printing. In 1977 this operation had sales of $16.5 million, and for the first seven months of 1978, it showed revenues of $10.4 million. The Stafford-Lowden purchase price was between $12 million and $13 million in cash and notes.

90 Commenting on this move and other consolidation efforts, R. B. Erskine, corporate senior vice president for planning and development, stated:

> We took a hard-nosed approach to operations, and made demands for excellence. Every operating division and ultimately every individual unit came under scrutiny as to performance and long-term strategic significance. Some hard decisions were made which have been reflected in our improved performance this year and last year.
>
> As a direct result of significant improvements in operating performance, our debt ratio has declined. This, combined with a well-thought-out investment posture, also resulted in our current favorable cash position.
>
> As the balance sheet and physical operations came under control, we began to look to the company's future. An in-depth appraisal . . . has culminated in a commitment to develop as a hospitality company. Our emphasis will be heavily consumer oriented, encompassing areas such as lodging, food away from home, leisure-time activities, and related support services.
>
> In keeping with our desire to maintain a strong growth orientation and keep our operations highly profitable, the products group has been steadily streamlined since 1974 when it consisted of some 26 operations. The bulk of this activity was completed by 1977, when only six operating units remained . . . all of which were profitable.

91 With hotel operation still representing over 50 percent of Holiday Inns, Inc. total revenues, continuing growth and cost efficiency within this division is of paramount importance. When asked to comment on hotel operations now and for the future, Eric Bernard, president of the hotel group, responded:

> We have simplified our management structure from four regions to three. . . . We have sold 10 properties, but replaced them with five new and larger ones in high-demand, destination locations. To improve our product, we have committed over $150 million in 1978 for the construction of 5 new Holidome indoor recreation centers, 1,445 room additions at 15 properties and three new hotels.
>
> We expect installation of our operational management systems in the balance of our hotels by the first quarter of 1980. By the end of this year, each property will have completed a unit-level business plan. We have tested common menu items and reversed the downward trend in our food

and beverage operations and produced increases well in excess of industry averages.

After a systematic study, we came to the conclusion that with the implementation of a common restaurant system with consistent quality and consistent image, we can duplicate with our food operations the success we have had with our rooms.

We are now ready to introduce our new restaurant system, Pipers, on the national market. It is being implemented in our company hotels in an all-out effort. Sixty installations will be completed by the end of this year. And 80 more will be completed by the first half of 1979. We have been working diligently behind the scenes to launch a suitable restaurant companion system to our hotel system.

Chains can offer the best value through standardization, which translates into mass purchasing, waste reduction, and labor efficiency. They can effect cost efficiency through multiple-unit advertising. Pipers will be a chain that has all of these attributes and we are confident of its success.

Now, let's turn to our international operations. We have moved forward and grown to 186 hotels open and 24 under construction, a net gain of 29 in one year. . . . We are in the midst of our second profitable year. For the three quarters to date, we have improved our profit by $4.9 million, or 72.5 percent over 1977.

Our international properties can provide business to the United States. Contributing to our increased referral business was our extension of Holidex this year to Hong Kong, Bahrain, Sydney, Kuala Lumpur, Manila, Sharjah, and Caracas. Further expansion in South America and to Africa is forthcoming.

Today, we are healthy and profitable. We have first-class management, operating on a decentralized basis in five international regions. We will continue to increase the profit from our existing properties and concentrate our energies on development in every part of the world where it is profitable and practical to operate. We will continue our policy of building local chains rather than building only one hotel in capital cities. And we will develop on a wide base to ensure that our profitability is not overdependent on one area of the world.

92 Additional financial information is included in Exhibits 11, 12, and 13. System-wide hotel occupancy has steadily improved from a low of 65.4 percent in 1975 to a 10-year high of 74.3 percent in 1978. And this has occurred even while the average room rate rose .60 percent from $21 to $33 in the same period. These results suggest there is plenty of room for a medium-priced Holiday Inn even in the face of budget-chain proliferation.

93 While overall corporate performance, and particularly the hotel group, has been satisfactory in recent years, some areas give cause for concern. Delta steamships, while doubling its revenue in one year, encountered an alarming drop in profitability ($10 million) over the same year. Attributed to management difficulties in accommodating rapid expansion as well as intense foreign competition, this nonetheless is an area of concern to corporate management. Similarly, Trailways has not been able to return to its 1974–75

exhibit 11

HOLIDAY INNS, INC. AND CONSOLIDATED SUBSIDIARIES
Consolidated Summary of Operations
For the Years 1974–1978
($000, except per share)

	1978	*Percent*	*1977*	*Percent*
Revenues:				
Hotel	$ 649,217	54.0	$ 589,389	56.9
Products	148,102	12.3	143,581	13.9
Transportation				
Bus	268,098	22.3	244,376	23.6
Steamship	155,004	12.9	80,106	7.7
Other	14,177	1.2	6,096	.6
	1,234,598	102.7	1,063,548	102.7
Elimination of products intersegment revenues	(32,389)	(2.7)	(28,274)	(2.7)
	$1,202,209	100.0	$1,035,274	100.0
Operating income:				
Hotel	$ 116,548	74.3	$ 90,073	69.1
Products	6,228	4.0	6,561	5.0
Transportation				
Bus	19,717	12.6	16,420	12.6
Steamship	7,776	5.0	17,326	13.3
Other	8,103	5.1	878	.7
	158,372	101.0	131,258	100.7
Elmination of products intersegment income	(1,570)	(1.0)	(957)	(.7)
	156,802	100.0	130,301	100.0
Corporate expense	(15,317)		(11,769)	
Interest, net of interest capitalized	(29,642)		(26,735)	
Foreign currency translation (loss) gain	(717)		(1,009)	
Income from continuing operations before income taxes	111,126		90,788	
Provisions for income taxes	48,335		38,131	
Income from continuing operations	62,791		52,657	
Discontinued operations, less applicable income taxes	—		—	
Net income	$ 62,791		$ 52,657	
Income per common and common equivalent share:				
Continuing operations	$ 2.04		$ 1.71	
Discontinued operations	—		—	
	$ 2.04		$ 1.71	
Cash dividends declared per common share	$ .56		$ .465	

1976	Percent	1975	Percent	1974	Percent
$539,400	55.9	$525,753	57.3	$502,300	55.5
137,232	14.2	116,185	12.7	139,868	15.4
234,722	24.3	210,723	23.0	202,770	22.4
81,063	8.4	82,816	9.0	77,843	8.6
5,378	.5	4,774	.5	4,482	.5
997,795	103.3	940,251	102.5	927,263	102.4
(32,169)	(3.3)	(23,278)	(2.5)	(22,158)	(2.4)
$965,626	100.0	$916,973	100.0	$905,105	100.0
$ 69,212	66.1	$ 60,878	60.1	51,910	51.4
1,662	1.6	938	.9	9,036	8.9
15,366	14.7	20,011	19.7	25,578	25.3
17,585	16.8	18,100	17.9	12,472	12.4
2,015	1.9	2,360	2.3	3,059	3.0
105,840	101.1	102,287	100.9	102,055	101.0
(1.129)	(1.1)	(953)	(.9)	(996)	(1.0)
104,711	100.0	101,334	100.0	101,059	100.0
(9,200)		(9,745)		(14,161)	
(23,242)		(30,232)		(31,853)	
(3,076)		5,867		(8,614)	
64,193		67,224		46,431	
24,944		26,220		20,442	
39,249		41,004		25,989	
(400)		447		956	
$ 38,849		$ 41,451		$ 26,945	
$ 1.28		$ 1.34		$ .84	
(.01)		.01		.03	
$ 1.27		$ 1.35		$ .87	
$ .40		$ .35		$ .325	

exhibit 12

HOLIDAY INNS, INC.
Consolidated Balance Sheets
For the Years 1976–1978
($000)

	December 29, 1978	*December 30, 1977*	*December 31, 1976 (restated)*
Assets			
Current assets:			
Cash	$ 24,216	$ 20,529	$ 18,345
Temporary cash investments, at cost	138,205	70,758	43,257
Receivables, less allowance for doubtful accounts of $7,835,000 and $6,031,000	137,796	87,175	88,448
Inventories, at lower of average cost or	23,872	27,186	26,996
market	13,880	11,916	9,020
Other current assets	337,969	217,564	186,066
Less: Deposits to be made to capital construction fund	3,964	4,258	3,761
Total current assets	334,005	213,306	182,305
Capital construction fund, including above deposits	4,070	26,056	25,010
Investments and long-term receivables:			
Nonconsolidated subsidiaries and less-than-majority-owned affiliates	30,934	27,974	20,151
Notes receivable and other investments	37,895	46,025	31,021
	68,829	73,999	51,172
Property and equipment, at cost:			
Land, buildings, improvements, and equipment	1,140,843	1,068,118	1,026,586
Less: Accumulated depreciation and amortization	373,707	363,105	347,212
	767,136	705,013	679,374
Deferred charges and other assets	21,966	21,221	22,626
Total assets	$1,196,006	$1,039,595	$ 960,487

profitability levels. Faced with major capital improvements on its terminals and an industry-wide price/cost squeeze, Trailways cannot expect to return to these levels any time soon. Retrenchment in the products group has started to improve profitability, but it is still far below its early 1970s level.

For the future

94 Charles Barnette, director of corporate public relations, succinctly summarized the perspective adopted by Holiday Inns, Inc. for the future. He stated, "We want to focus business activities on markets and market segments where we can excel, achieve competitive advantage, and be the cost effective leader."

	December 29, 1978	December 30, 1977	December 31, 1976 (restated)
Liabilities and Stockholders' Equity			
Current liabilities:			
Long-term debt due within 1 year	$ 26,528	$ 28,707	$ 26,948
Notes payable—banks		548	3,771
Accounts payable	60,010	40,145	29,387
Accrued federal and state income taxes	43,779	30,774	16,606
Accrued expenses and other taxes	80,401	49,985	44,630
Other current liabilities	36,337	20,996	18,045
Total current liabilities	247,055	171,155	139,387
Long-term debt due after 1 year	322,177	310,164	299,388
Deferred credits	41,247	10,941	15,404
Deferred income taxes	33,139	42,531	40,557
Stockholders' equity:			
Capital stock			
Special stock: authorized 5 million shares;			
Series A; $1,125 par value; issued 760,296 and 760,358 shares; convertible into common	803	855	855
Common: authorized 60 million shares; $1.50 par value; issued 29,999,213 and 29,883,825 shares	45,435	44,999	44,826
Capital surplus	118,648	116,028	114,759
Retained earnings	395,982	350,995	313,301
	560,868	512,877	473,741
Capital stock in treasury, at cost	(7,492)	(6,705)	(6,331)
Unissued deferred compensation shares	(988)	(1,368)	(1,659)
	552,388	504,804	465,751
Total liabilities and stockholders' equity	$1,196,006	$1,039,595	$ 960,487

95 Some of the specifics that emerge from Barnette's statement are: (1) maintain a corporate debt ratio of 35 percent of invested capital; (2) increase corporate ROIC to over 13 percent; (3) grow at a rate of 15 percent or more per year; (4) achieve a dividend payment representing 35 percent of net income. While these corporate-wide objectives offer a realistic challenge, the future contribution of different business groups varies considerably.

96 During the period 1979–1983, the hotel group wants to increase the number of rooms by 72,000 and sell 75,000 new franchise rooms. Riding the crest of steady occupancy growth, the hotel system offered nearly twice as many rooms as its nearest competitor and sold one out of every three hotel chain-room nights in 1978. In the face of mounting budget-chain competition (see the "Note on the Lodging Industry" in the case section for more detail),

exhibit 13

HOLIDAY INNS, INC. AND CONSOLIDATED SUBSIDIARIES
Statements of Changes in Financial Position
For the Years 1976–1978
($000)

	Fiscal years		
	1978	*1977*	*1976*
Source of funds:			
Net income	$ 62,791	$ 52,657	$ 38,849
Add (deduct) items not affecting working capital:			
Depreciation, amortization, and allowance for property dispositions	67,824	63,034	60,483
Deferred income taxes	(8,068)	7,645	4,844
Other	1,603	1,306	3,906
Working capital provided from operations	124,150	124,642	108,082
Proceeds from financing	65,304	51,474	15,501
Decrease (increase) in capital construction fund	21,986	(1,046)	(2,201)
Increase (decrease) in unterminated voyage revenue	9,025	(3,764)	14
Deferred gain on sale of real estate	21,550	—	—
Depreciated value of property dispositions	40,007	26,470	25,209
Total sources	282,022	197,776	146,605
Application of funds:			
Expenditures for property and equipment	169,116	112,091	70,247
Payment of mortgages and notes	57,107	43,439	52,393
Dividends declared	16,657	13,787	11,810
Increase (decrease) in investments and long-term receivables	(7,383)	22,721	10,410
Reduction in deferred income taxes	1,3245	5,671	1,619
Other	402	834	6,142
Total applications	237,223	198,543	152,621
Increase (decrease) in working capital	$ 44,799	$ (767)	$ (6,016)
Changes in components which increased (decreased) working capital:			
Cash and temporary cash investments	$ 71,134	$ 29,685	$ 441
Receivables	50,621	(1,273)	7,517
Inventories	(3,314)	190	(7,210)
Other assets	2,258	2,399	2,426
Long-term debt due within 1 year	2,179	(1,759)	(361)
Accounts payable and other current liabilities	(65,074)	(15,841)	(6,073)
Accrued federal and state income taxes	(13,005)	(14,168)	(2,756)
Increase (decrease) in working capital	$ 44,799	$ (767)	$ (6,016)

Holiday Inn executives do not expect occupancy to drop due to price competition. Marketing research at corporate headquarters suggests that about half of all travelers prefer Holiday Inn hotels. They select Holiday Inns, according to this market research, because they want consistent room quality, good location, reliable worldwide reservation service, moderate prices, good food and beverage service, and well-maintained facilities. Holiday Inn hotel guests in 1978 came from all segments of age and income, with those between the age of 24 and 49, earning more than $20,000 a year, being the most prevalent groups. In three of four instances its guests were male, but

the trend to more women travelers has grown consistently as more and more women enter the work force. Thus, Holiday Inn management concludes, price is not as important as the "price/value" ratio. And they are confident Holiday Inns are positioned to offer the best price/value in the industry.

97 In regard to the transportation group, the company is lobbying vigorously in favor of municipal ownership of bus terminals. Unfortunately, this has met with little success to date. The movement in the passenger transportation industry, as evidenced by deregulation of airlines, is toward decreased government involvement. Business analysts have forecasted continued hard times for the intercity bus industry, caught between rising energy, labor, and maintenance costs on the one hand and increasing price competition, particularly with airlines, on the other. An article in *Fortune* magazine concludes that Greyhound and Trailways' current price war is hurting only each others' profitability, without producing any additional share of the long-haul business which is now dominated by the airlines at fares only 50 percent above the discount bus fares.[4]

98 Since 1974, the number of scheduled passengers has increased by 25 percent for airlines while it has declined over 32 percent for buses.

99 Like Trailways, Delta's recent performance and competitive environment have caused concern for the future of the steamship operations. But Delta's strong revenue growth and its position as the major Gulf port U.S.-flag carrier on South American cargo routes have executives encouraged.

100 Objectives for the restaurant group include the achievement of an earnings growth of 15.9 percent annually, and an ROIC of 10 percent. Demographic trends that favor the hotel and gaming areas also favor freestanding restaurants. However, with this primary market expansion has come increasing competition nationwide. Major competition now comes from existing, family-oriented chains like Shoney's, Denny's, and Sambo's as well as the increasingly overlapping fast-food chains. And firms like Pillsbury are making major moves into this away-from-home eating market with its acquisition of Burger King, Steak and Ale, and other smaller chains. Nonetheless, market trends and synergy with Holiday Inns' food and franchising experience keep management optimistic.

101 The company invested much money and time in its research on the gaming industry. Company research indicates that casino revenues have grown at a 14 percent compound annual rate since 1948, that the gaming market has been recession proof, and that gaming has demographics similar to those of Holiday Inn's lodging customers. Increased future emphasis in this area is virtually assured.

102 Energy promises to be a major factor in the future success of each business group at Holiday Inns. Occupancy at Holiday Inn hotels is influenced by the availability and cost of gasoline. Metropolitan area and resort locations are affected to a lesser extent than roadside locations. The cost of

[4] "The Bus Lines Are on the Road to Nowhere," *Fortune,* December 31, 1978, pp. 58–64.

gasoline has increased steadily and is expected to continue to rise, particularly since the decontrol of petroleum prices is a virtual certainty. Gasoline shortages are possible in the future, and they may have adverse effects on the hotel business of Holiday Inns. In an effort to reduce the impact of shortages on its business, the Holiday Inns is emphasizing metropolitan area, airport, and resort locations in its current hotel development programs. The casino business (Nevada and New Jersey) is similarly sensitive to the cost and availability of gasoline. Likewise, Trailways' and Delta's businesses are sensitive to the availability and cost of fuel.

103 In a recent *Fortune* article, Holiday Inns and Best Western foresee radically different scenarios regarding the impact of gasoline prices on the lodging business.[5] Robert Hazard, CEO at Best Western International, says that their research shows a 7 percent cutback in travel when gas hits $1.50 a gallon and a 17 percent cutback when prices hit $2 a gallon. James Schorr, marketing vice president at Holiday Inns, says "Best Western is plain wrong. Even at $2 a gallon, he says, "we are absolutely certain that higher (gasoline) prices are not going to significantly impact *highway* use of the automobile." As if to reinforce this assumption, Holiday Inns 1979 annual report offered the following insert:

> The decade of the 1980s offers excellent potential for the lodging industry. Business analysts see continued growth for travel through the end of the century.
>
> While temporary gasoline shortages have been a short-term negative factor in our operations twice in the past six years, we remain quite optimistic about gasoline availability for our customers. We expect occasional brief shortages, but by and large, we believe that adequate supplies will be available.
>
> Our optimism is fostered by a significantly more efficient car fleet and rising energy prices. The 1980 auto fleet is 55 percent more fuel efficient than its 1974 counterpart. In 1985, the average car will travel 27.5 miles per gallon of gas, a 37.5 percent increase over 1980. As gasoline prices rise, we believe the consumer will be more selective. Conservation is already becoming the rule and needless intracity travel is being curtailed. Our research tells us that our customers will continue to use their automobiles for intercity travel and vacations. Thus, we believe we are strongly positioned for the coming decade, especially as demand for our rooms will continue to outgrow supply.

104 To summarize their optimism about the future, Kemmons Wilson, chairman of the board, placed all corporate objectives for the future in a concise framework. He stated:

> Now it's time to embark on a new era of growth and to continue the very favorable trends for our shareholders that we've seen in the past two years. The outlook on tourism in this country and worldwide has never been bet-

[5] "Somebody Must Be Wrong," *Fortune*, April 14, 1980, pp. 86–87.

> ter. We are truly becoming a unified world where people are traveling farther, more frequently, and for more reasons.
>
> Twenty-seven years ago I had a dream. It has been fulfilled. But even in my wildest dreams I could not see the changes that were ahead. I never dreamed that so many people would travel between countries. Or that people would choose to spend a weekend in their own hometown, or that people would begin to eat more meals away from home than at home, or that forms of acceptable entertainment would change so dramatically.
>
> Today we have a better picture of the future, and at Holiday Inns, Inc. I am proud to say we're anticipating change. In fact, we welcome it. And we're determined to be out in front in whatever markets we are able to serve.

105 "Whatever markets we are able to serve" may have a double meaning for Holiday Inns as it moves into the 1980s. Is it a challenge for further diversification of this travel-related company or a call for urgent reexamination of what its mission and business definition should be?

106 Embarking on a new era of growth will be managed, for the first time in over a quarter of a century, without the presence of Kemmons Wilson. On May 16, 1979, Kemmons Wilson announced his retirement, effective June 30. At the annual stockholders meeting, held in Memphis, Wilson made this announcement in conjunction with strong words of praise for his business associates and a strong vote of confidence for the company he founded. Wilson stated:

> I have had an opportunity that no one else has had. I have seen the company take my original vision of a standardized lodging concept and turn it into the largest hotel chain in the world.
>
> As I reflect upon what we have accomplished and I study our plans for the future, I am firmly convinced that we are embarking on a new era of growth. My optimism is based upon our management organization and the favorable trends that we see in tourism throughout this country.
>
> It is also important to recognize that more people are moving into the prime lodging customer age, 25–45 years old. The baby boom has grown up. This trend will favorably impact Holiday Inns, Inc., for many years to come.

chapter 1 cohesion case

Strategic management and Holiday Inns, Inc.

Chapter 1 has provided you with a broad introduction to strategic management. What role does strategic management play (or could it play) at Holiday Inns? Based on the material in Chapter 1, this question can be answered by addressing four issues:

1. Is Holiday Inns Facing a strategic decision?
2. What is Holiday Inns' strategy?
3. What value would strategic management offer Holiday Inns?
4. What strategic management structure is appropriate at Holiday Inns?

Is Holiday Inns facing a strategic decision? Yes! The energy crisis, especially as it affects the price and supply of gasoline, is a strategic issue and necessitates a strategic decision. It produced a sharp drop in earnings in the early 1970s. This could happen again. Holiday Inns' two biggest businesses—hotels and transportation (bus system)—are directly linked to this issue.

Other issues also foretell a need for strategic decisions. Budget motels are expanding. This threatens the hotel business in the 1980s and it is the key revenue generator. Holiday Inns is trying to diversify, but the percentage breakdown of revenues shows little change since 1974. Why? Is Holiday Inns' management not seriously pushing diversification? Is the necessary expertise lacking? The recent move into casino gaming potentially represents a major philosophical change for the company, as evidenced by the resignation of President L. M. Clymer. Is this to be a sideline operation or a serious future commitment? What ramifications, in light of Clymer's resignation, does this have for Holiday Inns' top-management structure and cohesion? With Holiday Inns still dependent on hotels/motels for 55 percent of its revenue, is there still room for growth or is the domestic (and international?) market becoming saturated? With the departure of Kemmons Wilson, has Holiday Inns completed the evolution from an entrepreneurially run company to a professionally managed one? Clearly, Holiday Inns faces numerous strategic decisions as described in Chapter 1.

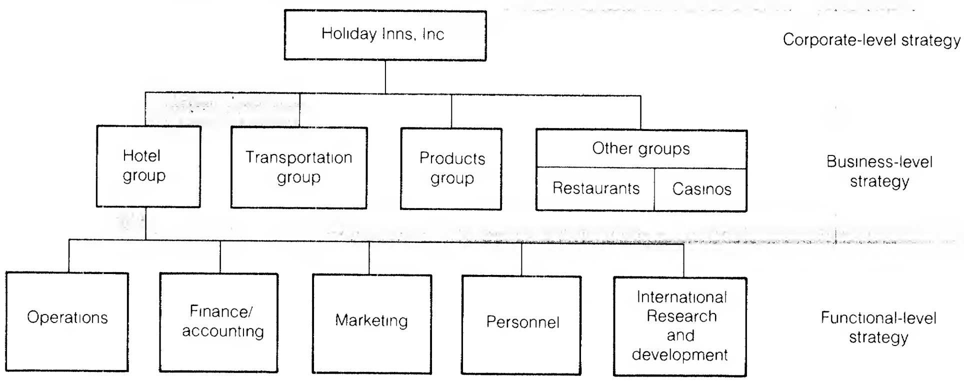
What is Holiday Inns' strategy? Holiday Inns appears to be pursuing steady growth through gradual, concentric diversification into hospitality-related businesses. Its business portfolio is still dominated by the hotel division. But the product and transportation divisions now represent just under 50 percent of Holiday Inns' revenues.

What value does strategic management offer Holiday Inns? With the

numerous strategic issues facing Holiday Inns, systematic strategic management would appear essential for it to survive and prosper. While its nonhotel divisions represent approximately 46 percent of Holiday Inns' revenue, this breakdown has not changed significantly since 1974—raising the question of whether its long-term strategy is just to supplement the hotel core or to actually reduce its dependence on the hotel side of its business. Systematic strategic management clearly is needed to address this issue in looking to the 1980s. Holiday Inns' management also believes the need for strategic management is imperative, based on this comment in the 1979 annual report: "The strategic framework and management team of Holiday Inns, Inc. are in place and we are well positioned for growth and accomplishment."

What strategic management structure is appropriate at Holiday Inns? Clearly, the multibusiness structure as presented in Figure 1–2 of Chapter 1 is called for at Holiday Inn. It could be illustrated as shown in Exhibit 1.

exhibit 1
Levels of strategy at Holiday Inns, Inc.



chapter 2

The strategic management process

BUSINESSES vary in the processes they use to formulate and direct their strategic management activities. Sophisticated planning organizations such as General Electric, Procter & Gamble, and IBM have developed more detailed processes than similarly sized less formal planners. Small businesses which rely on the strategy formulation skills and limited time of an entrepreneur typically exhibit very basic planning concerns when contrasted with larger firms in their industries. Understandably, firms with diverse operations due to their reliance on multiple products, markets, or technologies also tend to utilize more complex strategic management systems. However, despite differences in detail and the degree of formalization, the basic components of the models which are used to analyze their strategic management operations are very similar.[1]

Because of the similarity among general models of the strategic management process, it is possible to develop one eclectic model which is representative of the foremost thought in the area. Such a model was developed for this text and is shown in Figure 2-1. Called the strategic management model, it serves three major functions. First, it provides a visual display of the major components of the entire strategic management process. The model also shows conceptually how the components are related and how they are sequenced throughout the process. Second, the model will serve as

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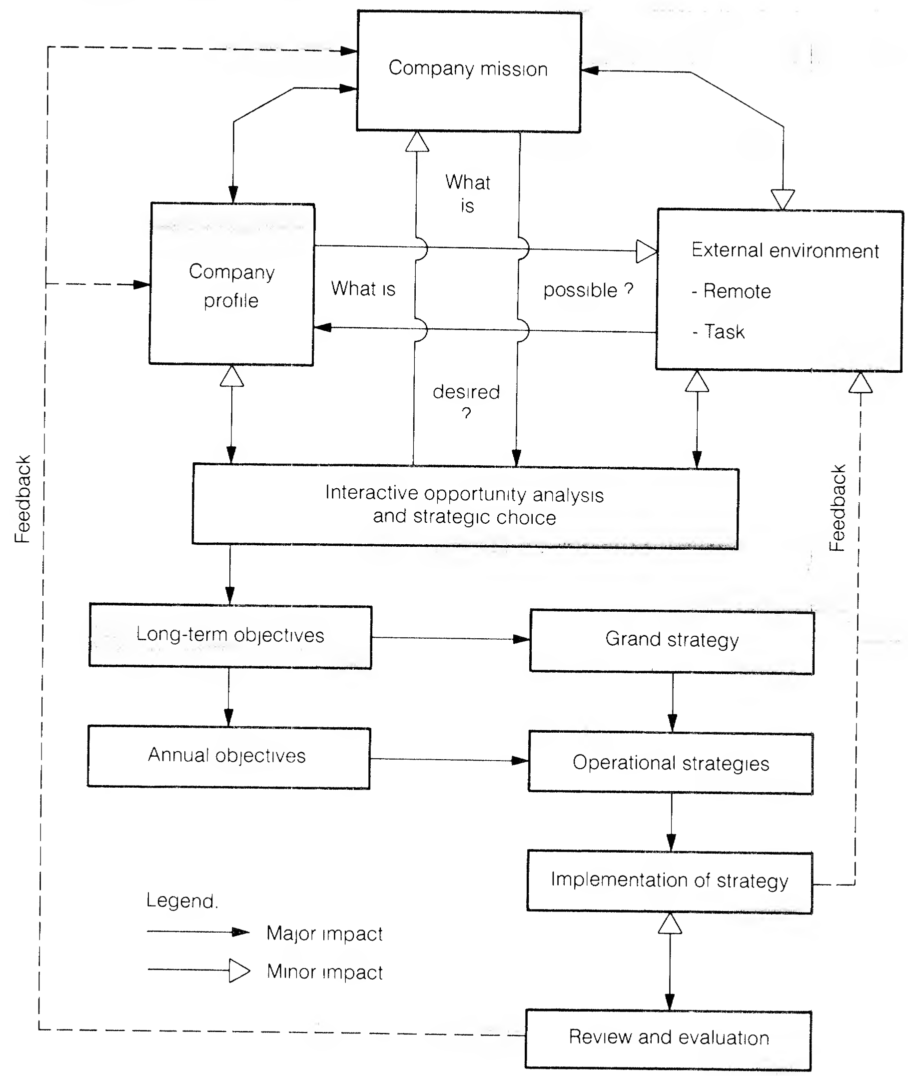
Note: Portions of this chapter are adopted from John A. Pearce II, "An Executive-Level Perspective on the Strategic Management Process," *California Management Review*, Spring 1982, pp. 39–48.

[1] Models by academic, typically developed from consulting experience and intended either for business or educational use, which reflect such similarity include those of Stevenson (1976), Rogers (1975), King and Cleland (1978), and numerous others. Models recommended for use by small businesses are almost identical to those recommended for larger firms, e.g., Gilmore (1973) and Steiner (1967). Finally, models which describe approaches for accomplishing strategic options contain similar elements to those of general models, e.g., Pryor on mergers (1964) and Steiner on diversification (1964). See the bibliography at the end of the chapter for complete citations.

figure 2-1
Strategic management model



the outline for this text. After providing a general overview of the strategic management process in this chapter, the major components of the model are used as the principal themes of subsequent chapters. Finally, the model is suggested for use as the format for analyzing the case studies included in this text. When used as the basis for case analysis, the model enhances the development of strategy formulation skills by guiding the analyzer through a systematic and comprehensive study of each business situation.

Components of the strategic management model

In this section the key components of the strategic management model will be defined and briefly described. Each component will receive much greater attention in a later chapter, and thus the intent here is simply to introduce the major concepts so that you can acquire an early feel for the concerns of the entire process.

Company mission

The mission of a business is the fundamental, unique purpose that sets it apart from other firms of its type and that identifies the scope of its operations in product and market terms. The mission is a general, enduring statement of company intent. It embodies the strategic decision makers' business philosophy, it implies the image the company seeks to project, it reflects the firm's self-concept, and it indicates the principal product or service areas and the primary customer needs which the company will attempt to satisfy. In short, the mission describes the product, market, and technological areas of emphasis for the business in a way that reflects the values and priorities of the strategic decision makers.

Because the conceptualization of company mission can be difficult to grasp, an excellent example is shown in Figure 2-2, which provides the mission statement of Nicor, Inc. as abstracted from an annual report to its stockholders.

Company profile

A company profile is the product of a firm's internal analysis which determines its performance capabilities based on existing or attainable resources. At any designated point in time, the company profile depicts the quantity and quality of financial, human, and physical resources available to the firm. It assesses the inherent strengths and weaknesses of the firm's management and organizational structure. Finally, the profile contrasts the historical successes of the firm, and the traditional values and concerns of its management with the firm's current capabilities in an attempt to identify the future capabilities of the business.

An example of one kind of analysis that contributes to the overall development of a company profile is the functional-area resource-deployment matrix. As shown in Figure 2-3, this analysis provides a yearly record for the firm of its level of commitment of each functional area. This approach enables the firm to quickly calculate the total investment which it has made to each functional area over time as a basis for better understanding its comparative and competitive strengths and weaknesses.

figure 2-2
Mission statement of Nicor, Inc.

Preamble

We, the management of Nicor, Inc., here set forth our belief as to the purpose for which the company is established and the principles under which it should operate. We pledge our effort to the accomplishment of these purposes within these principles.

Basic purpose

The basic purpose of Nicor, Inc., is to perpetuate an investor-owned company, engaging in various phases of the energy business, striving for balance among those phases so as to render needed satisfactory products and services and earn optimum, long-range profits.

What we do

The principal business of the company, through its utility subsidiary, is the provision of energy through a pipe system to meet the needs of ultimate consumers. In order to accomplish its basic purpose, and to assure its strength, the company will engage in other energy-related activities, directly or through subsidiaries or in participation with other persons, corporations, firms, or entities.

All activities of the company shall be consistent with its responsibilities to investors, customers, employees, and the public and its concern for the optimum development and utilization of natural resources and for environmental needs.

Where we do it

The company's operations shall be primarily in the United States, but no self-imposed or regulatory geographical limitations are placed upon the acquistion, development, processing, transportation, or storage of energy resources, nor upon other energy-related ventures in which the company may engage. The company will engage in such activities in any location where, after careful review, it has determined that such activity is in the best interest of its stockholders.

Utility service will be offered in the service territory of the company's utility subsidiary to the best of its ability, in accordance with the requirements of regulatory agencies and pursuant of the subsidiary's purposes and principles.

External environment

A firm's external environment consists of the sum total of all conditions and forces which affect the strategic options of a business but which are typically beyond its ability to control. The strategic management model shows the external environment of a firm as consisting of two interactive and interrelated segments: the remote environment and the task environment.

The remote environment refers to forces and conditions which originate beyond and usually irrespective of any single firm's immediate operating environment and which provide the general economic, political, social, and technological framework within which competing organizations operate. For example, a company's strategic planners and managers may face spiraling inflation (economic), import restrictions on their raw materials (political),

figure 2-3
A functional-area resource-deployment matrix

Functional areas	*Resource deployment emphasis*	*5 years ago*	*4 years ago*	*3 years ago*	*2 years ago*	*1 year ago*	*This year*
R&D and engineering	Percent strategic development dollars						
	Focus of efforts						
Manufacturing	Percent strategic development dollars						
	Focus of efforts						
Marketing	Percent strategic development dollars						
	Focus of efforts						
Finance	Percent strategic development dollars						
	Focus of efforts						
Management	Percent strategic development dollars						
	Focus of efforts						

Source: William F. Glueck, *Business Policy and Strategic Management* (New York: McGraw-Hill, 1980), p. 169.

demographic swings in the populations of the geographic areas they serve (social), or revolutionary technological innovations which make their production systems unexpectedly obsolete (technological).

The task environment refers to forces and conditions in a specific competitive operating situation, external to the firm, which influences the selection and attainment of alternative objective/strategy combinations. Unlike changes in the remote environment, changes in the task environment are

often the result of strategic actions taken by the firm or its competitors, consumers, users, suppliers, and creditors, or by appropriate regulatory groups. Thus, a consumer shift toward greater price consciousness, a loosening of local bank credit restrictions, a change of administrators in the regional OSHA office, or the opening of a new wholesale outlet by a competitor are all likely to have direct and intentional positive or negative impacts on a firm.

Interactive opportunity analysis and strategic choice

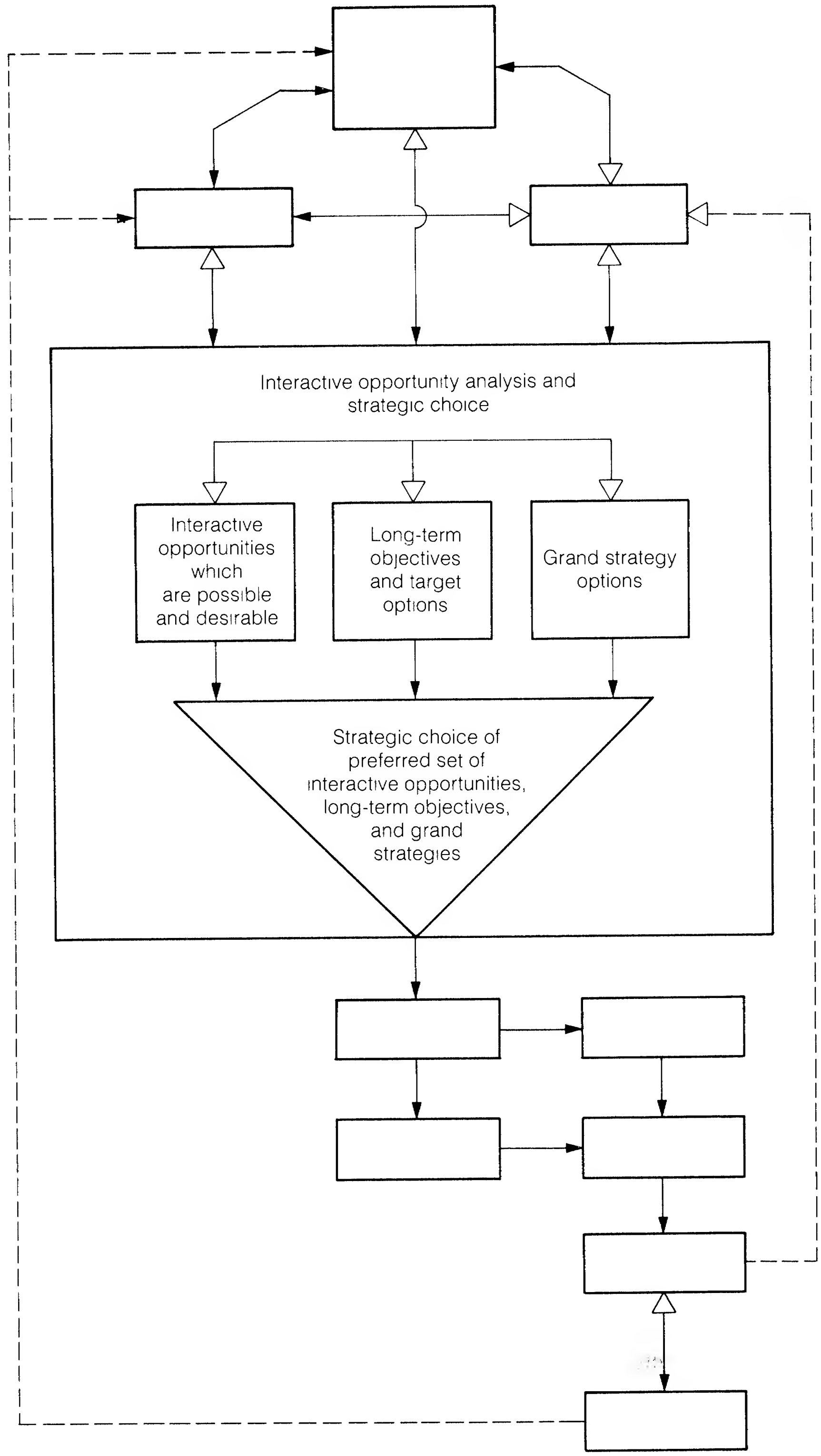
The simultaneous assessment of the firm's forecasted environment and its company profile enables a firm to determine the range of interactive opportunities which it might find attractive. These opportunities represent the alternatives which are *possible* avenues for investment. However, the full list must be screened through the criterion of the company mission before a set of possible and *desired* opportunities can emerge. This latter process is called strategic choice. Its purpose is to provide the combination of long-term objectives and grand strategy which will optimally position the total firm in the external environment as the means to achieving the company mission.

Consider a firm whose strategic managers feel that it is overly dependent on a single customer group, e.g., a chain of record shops whose principal customers are 10–20 years old. The firm's interactive opportunities might include expanding the product line, heavily emphasizing related products, accepting the status quo, or selling out profitably to a competitor. While each of these options might be possible, a firm whose mission stressed a commitment to continued existence as a growth-oriented, autonomous organization might find only the first two opportunities to be desirable. In that case, the two options would be evaluated on the basis of payoff and risk potential, compatibility with or capability for becoming the firm's competitive advantage, and other critical selection criteria.

The subprocess by which strategic choice is determined is complicated. Figure 2–4 magnifies the interactive opportunities analysis and strategic choice component of the strategic management model to enable greater detail. As the figure shows, strategic choice involves a process of matching each of the possible and desirable interactive opportunities with reasonable long-term objectives and targets. In turn, these are matched with the most promising approaches—known as grand strategies—for achieving the desired results. Each of the sets of alternatives is then evaluated individually and comparatively to determine the single set or group of sets which is expected to best achieve the company mission.

The critical assessment of strategic choice alternatives initially involves the development of evaluative criteria which will serve as the basis for comparing one set of alternatives with all others. As is the case in making any selection, the company's strategic choice process involves the evalua-

figure 2-4
Detailed component: interactive opportunities analysis and strategic choice



tion of alternatives which are rarely wholly acceptable or wholly unacceptable. The alternatives are therefore compared to determine which option will provide the most favorable overall, long-run impact on the firm.

Among the evaluative criteria which are used by businesses in assessing strategic choice alternatives are strategic managers' attitudes toward risk, flexibility, stability, growth, profitability, and diversification. Other factors which are included in the decision-making process are the volatility of the external environment, the life-cycle stages of the evaluated products, the company's current level of commitment to its organizational structure, its access to needed resources, its traditional competitive advantages, and the potential reaction of influential external or internal interest groups.

Long-term objectives

The results which an organization seeks to achieve over a five-year period of time are known as its long-term objectives.[2] Such objectives for a business are typically developed in some or all of the following areas: profitability, return on investment, competitive position, technological leadership, productivity, employee relations, public responsibility, and employee development. To be of greatest value each objective must be specific, measurable, achievable, and consistent with other objectives of the firm. Objectives state *what* is expected from pursuing a given set of business activities. Examples of many company objectives include the following: a doubling of earnings per share within five years with increases in each interim year; a move from the rank of third to second as a seller of commercial electrical fixtures in Oregon; and a decrease of 10 percent a year in undesirable employee turnover over the next five years.

Grand strategy

The comprehensive, general plan of major actions by which a firm intends to achieve its long-term objectives within its dynamic environment is called the grand strategy. This *statement of means* indicates how the objectives or ends of business activity are to be achieved. Although every grand strategy is in fact a fairly unique package of long-term strategies, 12 basic approaches can be identified. The purpose of any of these grand, or master, strategies is to guide the acquisition and allocation of resources over a period of time, typically five years. Admittedly, no single grand strategy, or even several in combination, can adequately detail the strategic actions which a business will undertake over so long a period. However, the commitment of a firm's strategic managers to a fundamental approach for positioning the business in the competitive marketplace provides a galvanizing central focal point for subsequent decision making.

[2] Five years is the normal, but largely arbitrary, period of time identified as long term.

Some brief examples of grand strategies include Hewlett Packard's technological innovation approach for capturing the high-profit margins on new products, First Pennsylvania's retrenchment approach for avoiding bankruptcy despite $75 million in 1980 losses, and General Electric's concentric diversification approach to enable growth through their acquisition of related business.

Annual objectives

The results which an organization seeks to achieve within a one-year period are referred to as annual objectives. The topic areas for short-run or annual objectives are similar to those for long-term objectives. The difference between the two types of objectives stem principally from the greater specificity which is possible and necessary to guide short-term strategies. For example, a long-term objective of increasing company-wide sales volume by 20 percent in five years might be translated into a 4 percent growth objective in year one. In addition, it is reasonable that this company-wide, short-run objective should be reflected in the planning activities of all major functions or divisions of the firm. The research and development department might be expected to suggest one major addition to the product line in the first and each following year, the finance department might set a complementary objective of obtaining the necessary $300,000 in funds for an immediate expansion of production facilities, and the marketing department might establish an objective of reducing turnover among sales representatives by 5 percent per year.

Operating strategies

Within the general framework of the grand strategy, a specific and integrative plan of actions is needed for each distinctive business function or division. Most strategic managers attempt to develop an operating strategy for each related set of annual objectives. For example, there will be an operating strategy for the marketing department to indicate how marketing's annual objectives will be achieved, one for the production department's objectives, and so on.

Operating strategies are detailed *statements of the means* that will be used to achieve objectives within the following year. The company's budgeting process is usually coordinated with the development of the operating strategies to ensure specificity, practicality, and accountability in the planning process.

Implementation of strategy

Implementation involves the management activity of acquiring and allocating financial resources in conjunction with the development of structures

and procedures necessary to operationalize a strategy. Prior to implementation, strategies are only ideas. Principally, implementation involves the assignment of responsibility for the success of all or part of a strategy to appropriate employees, along with the allocation of required resources. Implementation means putting strategies into action.

Five variables are commonly considered to be critical factors in the implementation of a strategy: tasks, people, structures, technologies, and reward systems. Successful implementation of company strategies requires that methods be effectively designed and managed which will efficiently integrate these factors. Thus, a major priority of implementation efforts involves synchronizing the interfaces between key resource components of the planning process.

Review and evaluation

An implemented strategy needs to be monitored in order to determine the extent to which it is resulting in the achievement of its objectives. The process of formulating a strategy is largely subjective despite often extensive efforts to reduce it to objective decision making. Thus, the first substantial reality test of the value of a strategy comes only after implementation has begun. Strategic managers must watch for early signs of the responsiveness of the marketplace to their strategies. They must also provide the means for monitoring and controlling to ensure that their strategic plan is followed correctly.

Although the early review and evaluation of the strategic process concentrates on market-responsive modifications of the strategy, the underlying and ultimate test of a strategy is its proven ability to achieve its ends—the annual objectives, long-term objectives, and mission. In the final analysis, a firm is only successful when its strategy achieves its objectives.

Strategic management as a process

The strategic management model shown in Figure 2–1 depicts a process. The term *process* refers to an identifiable flow of information through interrelated stages of analysis directed toward the achievement of an aim. In the strategic management process the flow of information pertains to the historical, current, and forecasted data on the business, its operations, and environment, which is evaluated in light of the values and priorities of influential individuals and groups—often called stakeholders—who are vitally interested in the actions of the business. The interrelated stages of the process refer to the 10 components which were discussed in the last section. Finally, the aim of the process pertains to the formulation and implementation of strategies which result in long-term achievement of the company's mission, and its near-term achievement of objectives.

There are several important implications of strategic management as a

process. First, it means that a change in any components of the system will impact on several or all other components. Notice that the majority of arrows in the model point two ways, suggesting that the flow of information or impact is usually reciprocal among components. For example, forces in the external environment influence the nature of the mission which a company's strategic managers and stakeholders design for the firm. Reciprocally, the existence of that company with that mission legitimizes the environmental forces and implicitly heightens competition in the firm's realm of operation. A specific example is that of a power company that is persuaded, in part by governmental incentives, that its mission statement should include a commitment to the development of energy alternatives. The firm might then promise to extend its research and development efforts in the area of coal liquification. Obviously, in this example, the external environment has affected the firm's definition of its mission, and the existence of the revised mission expectantly alters a competitive condition in the environment.

A second implication of strategic management as a process is the sequential nature of strategy formulation and evaluation. The strategic management process begins with the development or reevaluation of the company mission. This step is associated with, but essentially followed by, the simultaneous development of a company profile and an assessment of the external environment. These are, in order: strategic choice, definition of long-term objectives, design of grand strategy, definition of short-term objectives, design of operating strategies, implementation of strategy, and review and evaluation. The apparent rigidity of the process needs to be tempered by two qualifications.

1. The first is the need for a reevaluation of the strategic posture of a firm in any of the principal factors which determine or affect company performances. Entry to the product line by a major new competitor, death of a prominent board member, or replacement of the chief executive officer (CEO), or a downturn in positive market responsivenesses are among the thousands of changes which can prompt the need to reassess a company's strategic plan. However, no matter where the interest in a reassessment originates, the strategic management process begins with the mission statement.

2. Not every component of the strategic management process deserves equal attention each time a planning activity takes place. Firms in an extremely stable environment may find that an in-depth assessment is not required on a five-year schedule.[3] Often companies are well satisfied with their original mission statements, even after decades of operation and thus need to spend only a minimal amount of time in addressing that factor. Additionally, while a formal strategic planning process may be undertaken only on a five-year basis, objectives and strategies are usually updated each

[3] Formal strategic planning is not necessarily done on a rigid five-year schedule, although this is the most common period of time. In fact, some planners advocate planning on an irregular timing basis to keep the activity from being overly routine.

year. At these times, rigorous reassessments of the initial stages of the process are rarely undertaken.

A third implication of strategic management as a process is the necessity for feedback from implementation, review, and evaluation to the early stage components of the process. Feedback can be defined as the postimplementation results of a strategy which are collected as inputs for the enhancement of future decision making through the strategic management process. Therefore, as shown in Figure 2–1, it is important for strategic managers to attempt to assess the impact of their implemented strategies on their external environments so that future planning can reflect any changes which were precipitated by their own actions. They should also carefully measure and analyze the impact upon the need for possible modifications for the company mission.

A fourth and final implication of strategic management as a process is the need to view it as a dynamic system. *Dynamic* is a term used to describe the constantly changing nature of conditions which affect interrelated and interdependent strategic activities. Managers need to recognize the components of the strategic process as constantly evolving. They must remember that formal planning artifically freezes the changing conditions and forces in the company's internal and external environments, much as an action photograph freezes the movement of a swimmer. In actuality, change is continuous, and thus the dynamic strategic planning process must be constantly monitored to detect significant changes in any of its components as a realistic precaution against implementing a strategy which is obsolete.

Practical limitations of the model

It is important to understand the limitations of the strategic management model so as not to diminish its overall impact by overlooking its weaknesses. An awareness of how the model can be properly used will thereby help to ensure effective strategic management. Thus, in this section, three points will be stressed, namely, that the model is holistic, analytical, and nonpolitical.

The model is holistic. This means that users of the model believe that strategic planning should be initiated by a company's top management. Because of the broad perspective of these executives, the strategizing process works from general to specific. The business is first studied as a whole within the context of its competitive environment, then individual functions or divisions and eventually specific operational activities of the firm are involved in the strategic management process.

Some researchers have argued that in certain circumstances the holistic approach is inferior to a tactical approach to strategic planning.[4] With the tactical approach strategic managers work up through the firm in their study

[4] For example, see George W. McKinney III, "An Experimental Study of Strategy Formulation Systems" (Ph.D. diss., Graduate School of Business, Stanford University, 1969).

of its potential. Then, with this strongly operational view of the firm's strengths and weaknesses, the managers assess their firm's compatibility with its external environment.

The risk of using the holistic approach implicitly advocated by the strategic management model is that executives might be unrealistic in their planning because of a potential tendency to minimize the difficulties of implementing a plan. The holistic approach can somtimes lead managers to gloss over details that may eventually be critical to operationalizing the firm's strategies.

On the other hand, the tactical approach poses far greater risks to strategic managers. First, the tactical approach tends to create inflexibility in planning. Managers risk placing such a great priority on operational details that they overstate the extent to which the firm is locked in to the status quo. It is difficult to envision new interactive opportunities when initial planning activities stress narrow operational concerns. Second, the integration of planning activities is more difficult with the tactical approach. Lacking the kind of overall framework for planning which is characteristic of the holistic method, the initial phases of planning are often disjointed, leading to complications in developing a unified strategic plan. Third, and most damaging, the tactical approach leads to a concentration on the present rather than on the future of the firm which strategic planning is specifically intended to do. The emphasis is too often on improving current capabilities instead of satisfying anticipated needs.

In the final analysis it appears that the holistic approach advocated by the strategic management model is superior to tactical-type alternatives. However, users of the model should be alert to the shortcomings in planning which it fosters and should guard against their development. Specifically, users of the model should continually challenge themselves on issues pertaining to the data-gathering and implementation phases of their firm's strategic activities. In this context it is important to remember that although middle- and lower-level managers seldom vote in the strategic choice process, they are a principal source of the operational data on which the ultimate decisions are largely based. Therefore, their advice and critiques should be actively sought and carefully considered in all phases of the strategic management process.

A second major issue of concern in the use of the strategic management model is that it is analytical rather than prescriptive or procedural in nature. The model describes in a general sense the logical or analytical steps that many businesses actually use in conducting their strategic activities. However, it does not describe the procedures or routines which are necessary to carry out each step. Further, the model has not been proven through research as the *ideal* model. In fact, while there is considerable evidence that firms which undertaken formal strategic planning outperform nonplanners, somewhat different planning models were used by almost every business

that has been studied.[5] Thus, at this point in time, there is no known *best* model. As a result, no model should be seen as providing a prescription for the way by which strategic planning should be done. Therefore, in using the strategic management model, it should be remembered that the model builders are recommending the general approach that they believe will provide a sound basis for strategic planning, not a model which they are certain will lead to the best results. Thus it is important that users of the model are continually alert to the need for occasional additions or deletions to the overall planning activities. The model will be most valuable if it is treated as a dependable outline upon which strategic managers must construct individualized planning systems.

The third major limitation of the model is that it is nonpolitical in constitution. That is, a naive student of the model could be mislead and perceive the strategic management process as largely devoid of subjective assessments, biased interpretations, human error, self-serving voting by individual managers, intuitive decision making, favoritism, and other forms of political activity. In reality, most strategic management experts believe the opposite. Strategic management is a behavioral activity and, as such, is vulnerable to the same pitfalls as other people processes. It is truly a management process. People involved in all phases of the strategy formulation and implementation must be skillfully organized, lead, planned about, and controlled. For this reason, we discuss the behavioral implications of each phase of the strategic management process extensively throughout this book. However the limitation of the strategic management model per se is that it presumes that strategic planners are skilled managers, and that they are sensitive to the people-related issues that continuously arise throughout every phase of the strategic management process.

The effects of political activity on the strategic management process are critical to its effective functioning and are a principal determinant of the plan's final composition. Thus, effective strategic managers must be attentive to this political realization and attempt to skillfully manage the inevitable people-related concerns.

Summary

This chapter has presented an overview of the strategic management process. The model which was provided will serve as a structure for understanding and integrating all of the major phases of strategy formulation and implementation. Although each of these phases is given extensive individual

[5] See, for example, Ansoff et al. (1971), Burt (1978), Eastlock and McDonald (1970), Herold (1972), Karger and Malik (1975), Malik and Karger (1975), Rue and Fulmer (1972), Schoeffler et al. (1974), Thune and House (1970), and Wood and LaForge (1979), all listed in the bibliography to this chapter.

attention in subsequent chapters, it is important that you acquire an early feeling for its process nature.

The chapter stressed that the strategic management process centers around the belief that the mission of a firm can best be achieved through a systematic and comprehensive assessment of both a firm's resource capabilities and its external environmental conditions. The subsequent evaluation of the company's opportunities leads in turn to the choice of long-term objectives and grand strategies and, ultimately, to annual objectives and operating strategies which must be implemented, monitored, and controlled.

The use of the holistic approach to strategic management was found to be favorable to a tactical one. However, three potential problems with the holistic method were discussed as well as means by which their negative impact can be minimized.

Questions for discussion

1. Think about the course work which you have had in the functional areas, such as marketing, finance, production, personnel, and accounting. What is the importance of each of these areas to the strategy planning process?
2. Discuss with practicing business managers the strategic planning approaches which are used in their businesses. What similarities and differences are there between their models and the one in the text?
3. In what ways do you believe that the strategic planning approach would differ between profit-oriented and not-for-profit organizations?
4. How do you explain the success of businesses which do not use a formal strategic planning process?
5. Think about your postgraduation job search as a strategic decision. How would the model be helpful to you in identifying and securing the most promising position?
6. Find the collection of corporate annual reports on file in your school's library. Can you find a report which includes a good mission statement? Does it exhibit the characteristics for a company mission as described in this chapter?

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chapter 2 cohesion case

Strategic management framework for Holiday Inns, Inc.

Chapter 2 has presented you with a framework for the strategic management process. How would you apply it at Holiday Inns, Inc.?

Holiday Inns, Inc., is a multibusiness firm. As such, it must have an overall corporate-level strategy to address decisions regarding its portfolio of businesses and to guide strategic decisions by key managers within each business group. Secondly, *each* business group must formulate and implement a business-level strategy to guide its resource deployment and pursuit of opportunity in a manner consistent with overall corporate objectives.

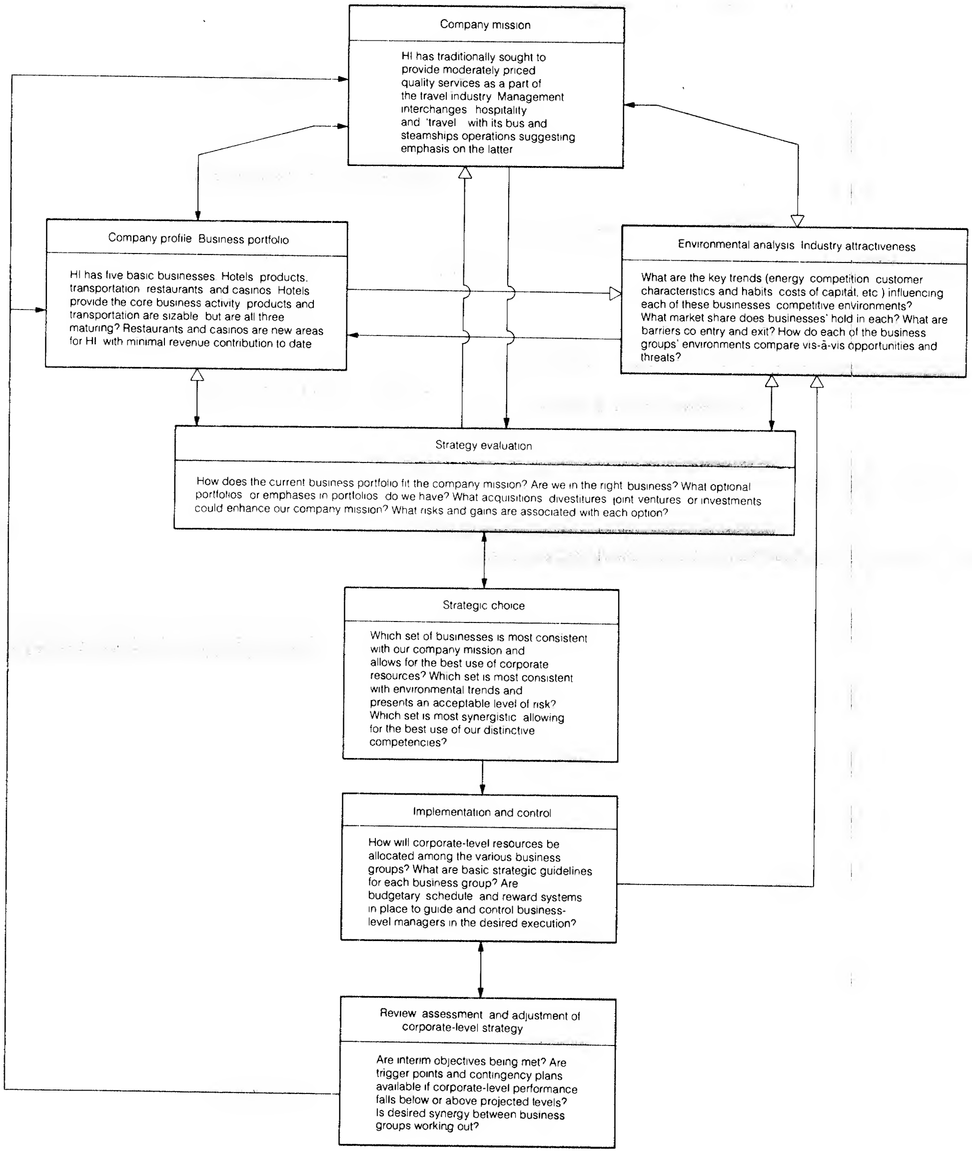
The purpose of Chapter 2 was to introduce you, in a broad sense, to a logical process for developing and implementing a strategy. While it briefly discussed each component, the remaining eight chapters will discuss each component in greater detail. Thus, your objective at this point is to apply in a general sense Chapter 2's strategic management paradigm to Holiday Inns, Inc.

As assistant to the president, how would you approach strategy development at Holiday Inns? We have provided two illustrations of the approach you might take based on the material in Chapter 2.

Looking to the 1980s, you must first address corporate-level strategy at Holiday Inns. Exhibit 1 shows how you might go about addressing corporate-level strategy. This is a critical issue at Holiday Inns. What should its company mission be? Is it a travel business or a hospitality business? How does the current portfolio of business groups fit this overall mission? What do the trends in the competitive environment(s) suggest for each group and the overall mission? What alternative portfolios are available? Which is best? What guidelines must be given to business groups to ensure their strategy is consistent with and supportive of the chosen corporate strategy? These are some of the issues you should endeavor to address in the designing of the corporate-level side of your strategic management process at Holiday Inns.

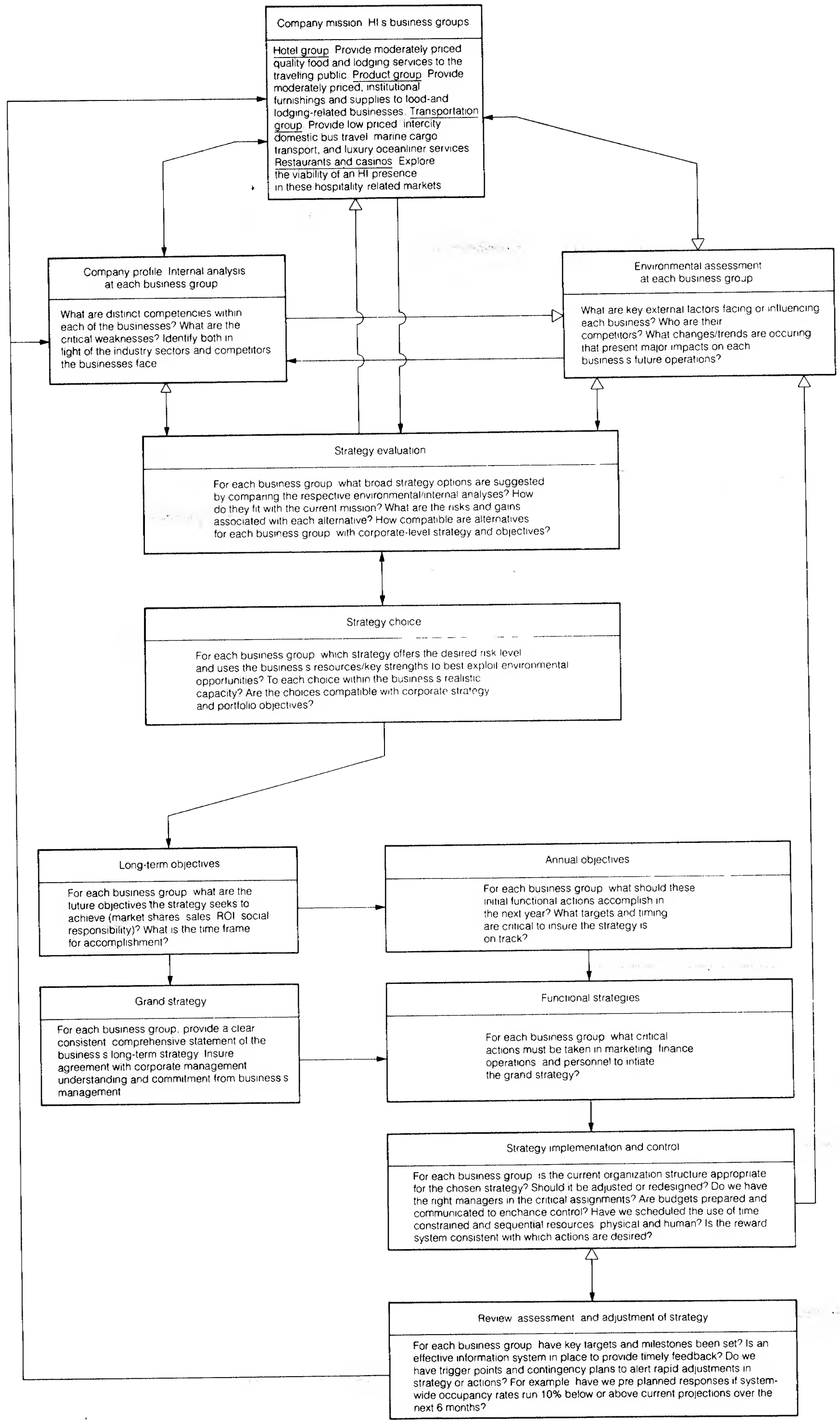
Your strategic management process at Holiday Inns must also address the formulation and implementation of business-level strategy for each business group. Exhibit 2 shows how you apply the material in Chapter 2 to organize the strategic management of each business group. The mission of the hotel group may be quite different from the transportation group or the casino group. Each business group presents its own strengths and weaknesses. Their competitive environment presents different opportunities and threats. Alternative strategies, emanating from a comparison of internal capacity and

exhibit 1
Corporate-level strategic management process



environmental opportunities, must be evaluated for each business group. A strategy must be chosen, implemented, and controlled for each business group that stakes out a desired competitive position consistent with the role of the business group as conceived within the corporate-level strategy.

exhibit 2
Business-level strategic management process



part two

Strategy formulation

THE process of strategy formulation is designed to guide executives in defining the business that their company is in, the aims that it seeks, and the means that it will use to accomplish them. Strategy formulation involves an improved approach to traditional long-range planning. As we discuss in the following six chapters, strategy formulation combines a future-oriented perspective with concern for a firm's internal and external environments in developing a company's competitive plan of action.

The process of strategy formulation begins with a definition of the company mission as discussed in Chapter 3. In this chapter you will learn to define the purpose of business in a way that reflects the values of a wide variety of interested parties.

In Chapter 4, you will learn about the principal factors in a firm's external

environment which strategic managers assess in order to anticipate and thereby take advantage of future business conditions. Chapter 5 focuses on environmental forecasting—the approaches which are currently used by strategic managers to assess and to anticipate changes in their external environments.

Chapter 6 shows you how businesses evaluate their internal strengths and weaknesses in a way that produces a company profile. Such profiles are used by strategic managers in order to target competitive advantages which they can emphasize and competitive disadvantages which they should correct or minimize.

In Chapter 7 you will read about the types of long-range objectives that are set by strategic managers and about the qualities that these objectives must have in order to provide a basis of direction and evaluation. You will also learn about the 12 grand strategies which companies use as the broadly defined approaches for achieving long-range objectives. Then you will study two techniques that executives can use to select the most promising grand strategies from among all of their available alternatives.

Detailed comprehensive approaches for the evaluation of strategic opportunities and for the final strategic choice decision are the focus of Chapter 8. You will learn how to compare strategic alternatives in a way that will enable you to select the best available option for a firm as measured by its potential for satisfying the company purpose.

chapter 3

Defining the company mission

AS the initial task in the development of a new business or as a key task in the reformulation of direction for an ongoing company, strategic decision makers must determine the basic goals, characteristics, and philosophies which will shape the strategic posture of the firm. Known as the statement of *company mission,* the outcome of this task will provide the basis of an enduring culture to guide future executive action. Thus, the company mission is defined as the fundamental, unique purpose that sets a business apart from other firms of its type and identifies the scope of its operations in product and market terms. As we discussed in Chapter 2, the mission is a broadly framed but enduring statement of company intent. It embodies strategic decision makers' business philosphy, it implies the image the company seeks to project, it reflects the firm's self-concept, and it indicates the principle product or service areas and the primary customer needs which the company will attempt to satisfy. In short, the mission describes the product, market, and technological areas of emphasis for the business in a way that reflects the values and priorities of the strategic decision makers.

Figure 3–1 presents an example of good mission statement. It incorporates the major features and provides the broad framework for the strategic decision making required of a company mission. The mission statement is from an internal communication of the Zale Corporation. The company has annual sales of $1 billion from four major lines of business: jewelry ($700 million), sporting goods, footwear, and drugs. Best known for their 769 Zale Jewelers stores, the Zale Corporation enjoys operating profits of approximately $130 million per year.

The need for an explicit mission

The process of defining the company mission is time consuming, tedious, and not required by any authoritative body external to the firm. It contains

Note: Portions of this chapter are adopted from John A. Pearce II, "The Company Mission As a Strategic Tool," *Sloan Management Review,* Spring 1982.

figure 3-1
Zale Corporation—summary statement of corporate mission

Our business is specialty retailing. Retailing is a people-oriented business. We recognize that our business existence and continued success is dependent upon how well we meet our responsibilities to several critically important groups of people.

Our first responsibility is to our customers. Without them we would have no reason for being. We strive to appeal to a broad spectrum of consumers, catering in a professional manner, to their needs. Our concept of value to the customer includes a wide selection of quality merchandise, competitively priced and delivered with courtesy and professionalism.

Our ultimate responsibility is to our shareholders. Our goal is to earn an optimum return on invested capital through steady profit growth and prudent, aggressive asset management. The attainment of this financial goal, coupled with a record of sound management, represents our approach toward influencing the value placed upon our common stock in the market.

We feel a deep, personal responsibility to our employees. As an equal opportunity employer we seek to create and maintain an environment where every employee is provided the opportunity to develop to his or her maximum potential. We expect to reward employees commensurate with their contribution to the success of the company.

We are committed to honesty and integrity in all relationships with suppliers of goods and services. We are demanding but fair. We evaluate our suppliers on the basis of quality, price, and service.

We recognize community involvement as an important obligation and as a viable business objective. Support of worthwhile community projects in areas where we operate generally accrues to the health and well-being of the community. This makes the community a better place for our employees to live and a better place for us to operate.

We believe in the free enterprise system and in the American democratic form of government under which this superior economic system has been permitted to flourish. We feel an incumbent responsibility to insure that our business operates at a reasonable profit. Profit provides opportunity for growth and job security. We believe growth is necessary to provide opportunities on an ever-increasing scale for our people. Therefore, we are dedicated to profitable growth—growth as a company—and growth as individuals.

This mission statement spells out the creed by which we live.

few specific directives, only broadly outlined or implied objectives and strategies, and characteristically is a statement of attitude, outlook, and orientation rather than of details and quantitatively measurable targets.

What then is the definition of a company mission designed to accomplish? King and Cleland provide seven good answers:

1. To ensure unanimity of purpose within the organization.
2. To provide a basis for the motivation of the organization's resources.
3. To develop a basis, or standard, for allocating organizational resources.
4. To establish a general tone or organizational climate, e.g., to suggest a businesslike operation.
5. To serve as a focal point for those who can identify with the organization's purpose and direction and as an explication to deter those who cannot from participating further in the organization's activities.
6. To facilitate the translation of objectives and goals into a work-breakdown structure involving the assignment of tasks to responsible elements within the organization.
7. To provide a specification of organizational purposes and the translation of these purposes into goals in such a way that the cost, time, and

performance parameters of the organization's activities can be assessed and controlled.[1]

The process of formulating a mission

You can perhaps best understand the process of defining the mission for a specific business by thinking about a firm at its inception. The typical business organization begins with the beliefs, desires, and aspirations of a single entrepreneur. The sense of mission for such an owner-manager is usually based on several fundamental elements.

1. Belief that the *product* or *service* of the company can provide benefits at least equal to its price.
2. Belief that the product or service can satisfy a *customer need* currently not met adequately for specific market segments.
3. Belief that the *technology* to be used in the production process will provide a product or service which is cost and quality competitive.
4. Belief that with hard work and the support of others the business can do better than just *survive*, it can *grow* and be *profitable*.
5. Belief that the *management philosophy* that will be exhibited by the business will result in a favorable *public image* and will provide financial and psychological rewards for those willing to invest their labor and money in helping the firm to succeed.
6. Belief that the *self-concept* which the entrepreneur has of the business can be communicated and adopted by employees and stockholders of the company.

As the business grows or is forced by competitive pressures to alter its product/market/technology posture, the need may arise to redefine the company mission. But if and when it does, the revised mission statement will reflect the same set of elements as did the original. It will state the basic type of product or service to be offered, the primary markets or customer groups whose needs will be served, the technology to be used in the production or delivery of the product or service, the fundamental concern for survival through growth and profitability, the managerial philosophy of the firm, the public image that is sought, and the self-concept which the people affiliated with the company should have of the firm.

Basic product or service; primary market; principal technology

Three indispensable components of a mission statement are the specification of the company's basic product or service, its primary market, and its principal technology for the production or delivery of the product or service. We discuss the three components here under one heading because it is only in

[1] W. R. King and D. I. Cleland, *Strategic Planning and Policy* (New York: Van Nostrand Reinhold, 1979), p. 124.

combination that they answer the question of what the business activity the company is or will be. A good example of these three mission components is to be found in the business plan of ITT Barton, a division of ITT. Under the heading of business mission and the area served, the company presents the following information.

> The unit's mission is to serve industry and government with quality instruments used for the primary measurement, analysis, and local control of fluid flow, level, pressure, temperature, and fluid properties. This instrumentation includes flow meters, electronic readouts, indicators, recorders, switches, liquid level systems, analytical instruments such as titrators, integrators, controllers, transmitters, and various instruments for the measurement of fluid properties (density, viscosity, gravity) used for process variable sensing, data collection, control, and transmission. The unit's mission includes fundamental loop-closing control and display devices, when economically justified, but excludes broadline central control room instrumentation, systems design, and turnkey responsibility.
>
> Markets served include instrumentation for oil and gas production, gas transportation, chemical and petrochemical processing, cryogenics, power generation, aerospace, government and marine, as well as other instrument and equipment manufacturers.

This segment of the mission statement clearly indicates to all readers—company employees to casual observers—the basic products, primary markets, and principal technologies of ITT Barton, and it was accomplished in only 129 words.

Company goals: survival, growth, profitability

Three economic goals guide the strategic direction of almost every viable business organization. Whether or not they are explicitly stated, a company mission statement reflects the firm's intention to secure its *survival* through sustained *growth* and *profitability*.

Unless a firm is able to survive it will be incapable of satisfying any of its stakeholders' aims. Unfortunately, like growth and profitability, survival is such an assumed goal of the firm that it is often neglected as a principal criterion in strategic decision making. When this happens, the firm often focuses on terminal aims at the expense of the long run. Concerns for expediency, a quick fix, or a bargain displace the need for assessing long-term impacts. Too often the result is near-term economic failure owing to a lack of resource synergy and sound business practice. For example, Consolidated Foods, makers of Shasta soft drinks and L'Eggs hosiery, sought growth in the 1960s through the acquisition of bargain businesses. However, the erratic sales patterns of their diverse holdings forced the firm to divest itself of more than four dozen of the companies in the late 1970s. The resulting stabilization cost Consolidated Foods millions of dollars and hampered its growth pattern.

Profitability is the mainstay goal of a business organization. No matter

how it is measured or defined, profit over the long term is accepted as the clearest indication of the firm's ability to satisfy the principal claims and desires of employees and stockholders. The key phrase in the sentence is "over the long term." Obviously, short-term concerns for profitability as the basis of strategic decision making would lead to a focus on terminal aims. A firm might be misguided into overlooking the enduring concerns of customers, suppliers, creditors, ecologists, and regulatory agents. In the short term the results may show profit, but over time the financial consequences are likely to be disastrous.

An example of long-run costs which have offset profitability is found in the case of a Florida real estate firm which was brought to court by the Federal Trade Commission. The final settlement required the firm to refund almost $17 million to various customers. In addition, the company was to change its future pattern of business operations. Specifically, it was to provide a 10-day interval for purchasers to void their contracts; it was to carefully limit any promises concerning future installations of roads, sewers, and other amenities; and it was to include in its promotions a statement of the uncertainties in its plans for development.[2]

Growth of a firm is inextricably tied to survival and profitability. In this context, the definition of growth must be widely interpreted. Market share has been shown by the PIMS study to be strongly correlated with firm profitability. However, growth in the number of markets served, in the variety of products offered, and in the technologies used to provide goods or services also constitute important forms of growth. Thus, growth is seldom sought for its own sake but rather because it leads to improvements in the company's competitive ability. Growth means change, and proactive change is a critical necessity in the dynamic business environment.

Company philosophy

The statement of a company's philosophy, often called a company creed, usually accompanies or appears as part of the mission. It reflects or explicitly states the basic beliefs, values, aspirations, and philosophical priorities which the strategic decision makers are committed to emphasizing in their management of the firm. Fortunately, the topical content of company philosophies vary little from one firm to another. This means that business owners and managers implicitly accept a general, unwritten, yet pervasive code of behavior by which actions in a business setting can be governed and largely self-regulated. Unfortunately, statements of philosophy display so great a degree of similarity among firms, and are stated in such platitudinous ways, as to look and read more like public relations promotions rather than like the commitments to values that they are intended to be. If fact, these problems are so evident that strategic management scholar George Steiner

[2] "Florida Developer to Refund $17 Million to Buyers," *New York Times*, September 14, 1974.

figure 3-2
Brief illustrative résumé of table of contents of a company's philosophy statement

Item	*Purpose or value stated or sought*
Business mission	State thrust or grand design State market and product lines of business
Profitability	Dedication to profits
Interests to be satisfied and balanced	Devotion to public interest Devotion to interest of stockholders, employees, suppliers, and community
Quality	Seek high quality in products Stimulate high quality in management and employees
Efficiency	Seek low cost, high productivity
Atmosphere of enterprise	Good place for people to work Good company in which to invest Good company from which to buy
Observance of codes of conduct	Honesty Integrity Opportunity Leadership Fairness in all dealings Teamwork Development of employees Open opportunity for employees Preserve private enterprise system Be a good citizen Duty and loyalty Religious devotion

Source: Adapted from George A. Steiner, *Top Management Planning* (New York: Macmillan, 1969), p. 145. Copyright © 1969 by The Trustees of Columbia University in the city of New York. Reprinted with permission of Macmillan.

has been able to develop a virtual outline of the typical statement of company philosophy as shown in Figure 3-2. Nevertheless, cynicism toward the intent underlying strategic managers' development of a company philosophy is rarely justified. In almost all case they attempt, and often succeed, to provide a distinctive and accurate picture of the firm's managerial outlook. One such valuable statement is that of Zale Corporation, whose company mission was presented earlier in this chapter. As shown in Figure 3-3, Zale has subdivided its statement of management's operating philosophy into four key areas: marketing and customer service, management tasks, human resources, and finance and control. These subdivisions serve as a basis for even greater philosophical refinement than was provided through the mission statement itself. As a result, Zale has established especially clear directions for company decision making and action.

Public image

Particularly for the growing firm which is involved in a redefinition of its company mission, the issue of its public image is an important component. Both present and potential customers attribute certain qualities to a particular business. Gerber and Johnson & Johnson make safe products, Cross

figure 3-3
Zale Corporation—operating philosophy

1. Marketing and customer service.
   a. We require that the entire organization be continuously customer oriented. Our future success is dependent on meeting the customers' needs better than our competition.
   b. We expect to maintain a marketing concept and distribution capability to identify changing trends and emerging markets and effectively promote our products.
   c. We strive to provide our customers with continuous offerings of quality merchandise, competitively priced—stressing value and service.
   d. We plan to constantly maintain our facilities as modern, attractive, clean, and orderly stores that are pleasing and exciting places for customers to shop.
2. Management tasks.
   a. We require profitable results from operations—activity does not necessarily equate with accomplishment—results must be measurable.
   b. We recognize there are always better ways to perform many functions. Continuous improvement in operating capability is a daily objective of the entire organization.
   c. We expect all managers to demonstrate capabilities to plan objectives, delegate responsibilities, motivate people, control operations, and achieve results measured against planned objectives.
   d. We must promote a spirit of teamwork. To succeed, a complex business such as ours requires good communication, clearly understood policies, effective controls and, above all, a dedication to "make it happen".
   e. We are highly competitive and dedicated to succeeding. However, as a human organization we will make mistakes. We must openly acknowledge our mistakes, learn from them, and take corrective action.
3. Human resources.
   a. We must develop and maintain a competent, highly motivated, results-oriented organization.
   b. We seek to attract, develop, and motivate people who demonstrate professional competence, courage, and integrity in performing their jobs.
   c. We strive to identify individuals who are outstanding performers, provide them with continuous challenges, and search for new, effective ways to compensate them—utilizing significant incentives.
   d. Promotion from within is our goal. We must have the best talent available and, from time to time, will have to reach outside to meet our ever-improving standards. We heartily endorse and support development programs to prepare individuals for increased responsibility. In like manner, we must promptly advise those who are not geared to the pace, in order that they must make the necessary adjustments without delay.
4. Finance and control.
   a. We will maintain a sound financial plan that provides capital for growth of the business and provides optimum return for our stockholders.
   b. We must develop and maintain a system of controls that highlight potential significant failures early for positive corrective action.

Pen makes professional writing instruments, Aigner makes stylish but affordable leather products, Corvettes are power machines, and Izod is for the preppy look. Thus, mission statements should reflect the anticipations of the public whenever the goals of the firm are likely to be achieved as a result. Gerber's mission should not open the possibility for diversification into pesticides, or Cross Pen's into 39-cent brand-named disposables.

On the other hand, a negative public image often prompts firms to reemphasize the beneficial aspects of their existence as reflected in their mission. For example, as a result of what it saw as a disturbing trend in public opinion, Dow Chemical undertook an aggressive promotional campaign to fortify its credibility particularly among "employees and those who live and work in (their) plant communities." Dow's approach was described in their 1980 annual report:

> All around the world today, Dow people are speaking up. People who care deeply about their company, what it stands for, and how it is veiwed by others. People who are immensely proud of their company's performance, yet realistic enough to realize it is the public's perception of that performance that counts in the long run.

Company self-concept

A major determinant of any company's continued success is the extent to which it can relate functionally to its external environment. Finding its place in a competitive situation requires that the firm be able to realistically evaluate its own strengths and weaknesses as a competitor. This idea—that the firm must know itself—is the essence of the company's self-concept. Though the notion of a company's self-concept per se is not commonly integrated into theories of strategic management, scholars have appreciated its importance to an individual: "Man has struggled to understand himself, for how he thinks of himself will influence both what he chooses to do and what he expects from life. Knowing his identity connects him both with his past and the potentiality of his future."[3]

There is a direct parallel between this view of the importance of an individual's self-concept and the self-concept of a business. Fundamentally, the need for each to know the self is crucial, because the ability of either to survive in a dynamic and highly competitive environment would be severely limited without an understanding of the impact which either has or could have upon others, and vice versa.

Many researchers who have studied organizational behavior have personified the business firm. Hall has stated the belief that much of the behavior in organizations is organizationally based, suggesting that the business acts upon its members on other than individual and interactional bases.[4]

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[3] J. Kelly, *Organizational Behavior* (Homewood, Ill.: Richard D. Irwin, 1974), p. 258.

[4] R. H. Hall, *Organization—Structure and Process* (Englewood Cliffs, N.J.: Prentice-Hall, 1972), p. 11.

These authors stress that businesses are entities that act, reflecting a personality which transcends particular company members. As such, the firm can be seen as setting the parameters for decision making, based on aims of the business which can be different and distinct from individual aims of the firms' membership. Thus, the effects of organizational considerations are pervasive throughout the company's interactions:

> Organizations do have policies, do and do not condone violence, and may or may not greet you with a smile. They also manufacture goods, administer policies, and protect the citizenry. These are organizational actions and involve properties of organizations, not individuals. They are carried out by individuals, even in the case of computer produced letters, which are programmed by individuals—but the genesis of the actions remains in the organization.[5]

The actual role of the corporate self-concept in the business organization has been summarized by four statements.

1. The corporate self-concept is based on management perception of the way others (society) will respond to the corporation.
2. The corporate self-concept will function to direct the behavior of people employed by the company.
3. The actual response of others to the company will in part determine the corporate self-concept.
4. The self-concept is incorporated in statements of corporate mission in order for it to be explicitly communicated to individuals inside and outside the company, that is, for it to be actualized.[6]

A second look at the company mission of the Zale Corporation in Figure 3–1 reveals much about the business's self-concept. The strategic decision makers see the firm as socially responsive, prudent, and fiercely independent.

The claimant approach to company responsibility

In defining or redefining the company mission, strategic managers must recognize and acknowledge the legitimate claims of other stakeholders of the firm. These stakeholders include both investors and employees of the business as well as outsiders who are affected by the company's mission-directed actions. Such outsiders commonly include customers, suppliers, governments, unions, competitors, local communities, and the general public. Each of these interest groups has justifiable reasons to expect, and often to demand, that the company act in a responsible matter toward the satisfaction of their claims. Generalizing, stockholders claim appropriate returns on their investments, employees seek broadly defined job satisfaction, custom-

[5] Ibid., p. 13.

[6] E. J. Kelley, *Marketing Planning and Competitive Strategy* (Englewood Cliffs, N.J.: Prentice-Hall, 1972), p. 55.

ers want what they pay for, suppliers seek dependable buyers, governments want adherence to legislated regulations, unions seek benefits for members in proportion to their contributions to company success, competitors want fair competition, local communities want companies which are responsible citizens, and the general public seeks to have some improvement in the quality of life result from the existence of the firm.

However, when a specific business attempts to define its mission so as to incorporate the interests of these various claimant groups, such broad generalizations are insufficient. Four steps need to be taken:

1. Identification of claimants.
2. Understanding of their specific claims vis-à-vis the company.
3. Reconciliation and prioritization of the claims.
4. Coordination of claims with other elements of the mission.

Identification of claimants. In the left-hand column of Figure 3-4 are listed the commonly encountered claimants of a firm—to which the executive officer group should be added. Obviously though, every business faces a slightly different set of claimants who vary in number, size, influence, and importance. In defining its mission, strategic managers need to identify each claimant group and to weigh their relative ability to impact on the success of the firm.

Understanding claims. While the concerns of principal claimants tend to center around the general nature of claims described in the right-hand column of Figure 3-4, it is important for strategic decision makers to understand more specifically the demands which each group will make on the firm. Then, strategic managers will be both better able to appreciate the concerns of claimants and to initiate clearly defined actions in pursuit of accepted responsibilities.

Reconciliation and prioritization of claims. Unfortunately, the concerns of various claimants are often in conflict. For example, the claims of governments and the general public tend to limit profitability, which is the central concern of most creditors and stockholders. Thus, claims must be reconciled. In order for strategic managers to prepare a unifying approach for the company, they must be able to define a mission which has resolved the competing, conflicting, and contradictory claims placed on the company's direction by claimants and claimant groups. Internally consistent and precisely focused objectives and strategies require mission statements which display such a single-minded-though multidimensional—approach to business aims.

Claims on any business number in the hundreds, if not thousands—high wages, pure air, job security, product quality, community service, taxes, OSHA, EEOC, product variety, wide markets, career opportunities, company growth, investment security, high ROI, and many, many more. Al-

figure 3–4
A claimant view of company responsibility

Claimant to the business firm	*General nature of the claim*
Stockholders	Participate in distribution of profits, additional stock offerings, assets on liquidation; vote of stock, inspection of company books, transfer of stock, election of board of directors, and such additional rights as established in the contract with corporation.
Creditors	Participate in legal proportion of interest payments due and return of principal from the investment. Security of pledged assets; relative priority in event of liquidation. Participate in certain management and owner prerogatives if certain conditions exist within the company (such as default of interest payments).
Employees	Economic, social, and psychological satisfaction in the place of employment. Freedom from arbitrary and capricious behavior on the part of company officials. Share in fringe benefits, freedom to join union and participate in collective bargaining, individual freedom in offering up their services through an employment contract. Adequate working conditions.
Customers	Service provided with the product; technical data to use the product; suitable warranties; spare parts to support the product during customer use; R&D leading to product improvement; facilitation of consumer credit.
Supplier	Continuing source of business; timely consummation of trade credit obligations; professional relationship in contracting for, purchasing, and receiving goods and services.
Governments	Taxes (income, property, etc.), fair competition, and adherence to the letter and intent of public policy dealing with the requirements of fair and free competition. Legal obligation for businessmen (and business organizations) and obey antitrust laws.
Union	Recognition as the negotiating agent for the employees. Opportunity to perpetuate the union as a participant in the business organization.
Competitors	Norms established by society and the industry for competitive conduct. Business statesmanship on the part of contemporaries.
Local communities	Place of productive and healthful employment in the local community. Participation of the company officials in community affairs, regular employment, fair play, local purchase of reasonable portion of the products of the local community, interest in and support of local government, support of cultural and charity projects.
The general public	Participation in and contribution to the governmental process of society as a whole; creative communications between governmental and business units designed for reciprocal understanding; bear fair proportion of the burden of government and society. Fair price for products and advancement of the state of the art in the technology which the product line offers.

Source: From William R. King and David I. Cleland, *Strategic Planning and Policy,* © 1978 by Litton Educational Publishing, Inc., p. 153. Reprinted by permission of Van Nostrand Reinhold Company.

though most, if not all, of these claims are desirable ends for the company they cannot be pursued with equal emphasis. Claims must be prioritized in a way which reflects the relative attention which the firm will give to each major claim. Such emphasis is shown by the criteria used in strategic decision making; by the company's allocation of human, financial, and physical resources; and by the long-term objectives and strategies developed for the firm.

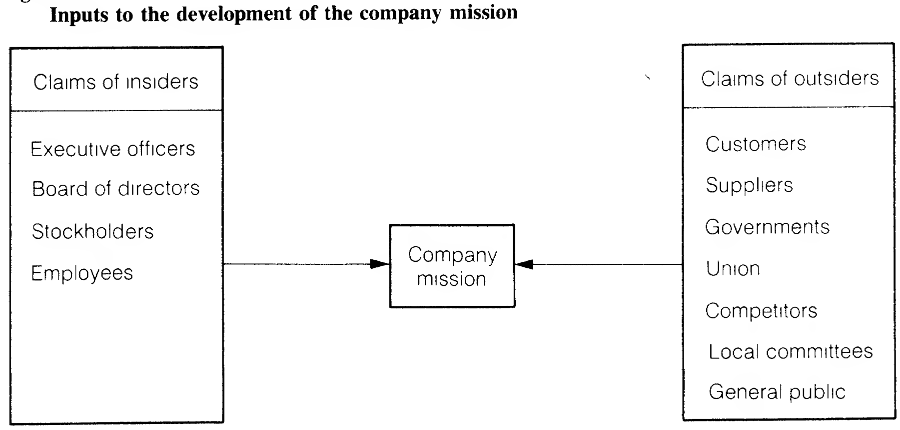
Coordinating elements of the mission. Demands on a company for responsible action by claimant groups constitutes only one set of inputs to the mission. Managerial operating philosophies and the determination of the product-market offering are the other principal components which must be considered. These factors essentially pose a reality test that the distilled set of accepted claims must pass in order to serve as a basis for a sound company mission. The key question to be addressed is: How can the company satisfy claimants and simultaneously optimize its success in the marketplace?

Social responsibility

The various claimants who make demands on a company can be divided into two categories, as indicated by Figure 3-5. Insiders are individuals and groups who are stockholders or are employed by the firm. Outsiders are all other individuals groups who are not insiders but who are impacted on by the actions of the firm as a producer and marketer of goods or services. This extremely large and often amorphous set of outsiders make the general claim on the company to be socially responsible.

The question of the appropriate nature of social responsibility for a business firm is perhaps the thorniest of all issues faced in defining a company

figure 3-5
Inputs to the development of the company mission



mission. The claimant approach offers the clearest perspective on the problem. Broadly stated, outsiders often demand that the claims of insiders be subordinated to the greater good of the society, that is, to the greater good of the outsiders. They believe that issues such as the elimination of solid and liquid wastes, the contamination of air and water, and the exhaustibility of natural resources should be principal considerations in the strategic decision making of the firm. Also broadly stated, insiders tend to believe that the competing claims of the outsiders should be balanced against each other in a way which protects the mission of the company. For example, the consumers' need for a product must be balanced against the water pollution resulting from its production, if the company cannot totally afford to eliminate the pollution and remain profitable. Additionally, some insiders argue that the claims of society, as activated by government regulation, provide tax money which is more than sufficient to eliminate unwanted business by-products, such as water pollution, if this is truly the wish of the general public.

The issues are so numerous and so complex, and the problems so situational as to defy rigid rules of conduct. Thus, each business must decide on the approach which it will use in trying to satisfy its perceived social responsibility. Different approaches will reflect differences in competitive positions, industries, countries, environmental and ecological pressures, and a host of other factors. In other words, they will reflect both situational factors and differing priorities in the companies' acknowledgements of claims.

Despite differences in their approaches, most American companies now take steps to assure outsiders of their efforts to conduct the business in a socially responsible manner. Many firms, including Abt Associates, Eastern Gas and Fuel Associates, and the Bank of America, have gone to the effort of conducting and publishing annual social audits. For example, see the social audit of Eastern Gas and Fuel, as published in their 1979 annual report, in Strategy in Action 3–1. These social audits attempt to evaluate the business from a social responsibility perspective. They are often conducted for the firm by private consultants who offer minimally biased evaluations on what are inherently highly subjective issues.

Many other firms periodically report to both insiders and outsiders on their progress to reach self-set social goals. Primarily through their annual reports, companies such as Diamond Shamrock discuss their efforts and their achievements in acting in a socially responsible fashion. Strategy in Action 3–2 provides the 1980 Diamond Shamrock report.

Guidelines for a socially responsible firm

After decades of debate on the topic of social responsibility, a business firm still must struggle individually to determine the orientation that should be reflected in its mission statement. However, public debate and business concern have led to a gelling of perspectives. One excellent summary of

guidelines for a socially responsible firm which is consitent with the claimant approach was provided by George Sawyer who offered four rules:

1. The purpose of the business is to make a profit; its managers should strive for the optimal profit that can be achieved over the long run.
2. No true profits can be claimed until business costs are paid. This in-

strategy in action, 3-1
Social audit of Eastern Gas and Fuel, 1979

Beyond financial concerns

Managing for profit is a common objective of all business, the cornerstone of the free enterprise system. However, business style varies widely. Eastern's philosophy is based on the premise that its performance objectives can be achieved in a manner that is responsive to the needs of Eastern's people—its shareholders, customers, employees, and the general public.

Corporate performance must be in line with shareholder expectations to justify their continued financial support. Service to Eastern's many customers must not be compromised. The selection and development of a highly skilled and motivated work force is essential. The work environment must be safe, healthy, and provide ample opportunity for self-improvement. The needs of the communities where Eastern has a presence must also be addressed.

In striving to meet all of these objectives, Eastern has established proper business conduct as a top priority.

A. Health and safety

	Number of fatalities		Incidence rate per 100 full-time workers* — Disabling injuries and illnesses		All injuries and illnesses	
	1979	*1978*	*1979*	*1978*	*1979*	*1978*
Coal	1	0	13.8	15.0	14.8	18.6
Coke	0	0	20.4	11.8	31.6	22.4
Gas	0	0	4.5	4.8	6.0	5.9
Marine	1	0	8.3	6.2	21.2	14.7
Total corporate	2	0	10.2	10.1	15.0	14.5

* The incidence rates represent the number of work-related injuries and illnesses × 200,000 (100 employees working 40 hours per week, 50 weeks per year) ÷ total hours worked by employees.

strategy in action, 3-1 *(concluded)*

B. Charitable giving

	Total charitable giving	
	1979	*1978*
Total contributions	$582,932	$512,161
Percent of pretax income*	.9%	.8%
Dollar per employee	$59.48	$51.73
Cost per share, after income tax	1.5¢	1.2¢

* Five-year average pretax income.

C. Minority employment

	Minority employment levels December 31			
	1979		*1978*	
	Number	*Percent of total*	*Number*	*Percent of total*
Officers and managers	28	1.9%	27	1.9%
Professional and technical	36	4.6	38	4.6
Clerical	92	9.7	91	9.9
Skilled	498	10.8	416	8.9
Unskilled	304	13.0	223	10.7
Total Eastern	958	9.5%	795	8.0%

D. Pensions

	Annual cost of pensions and welfare plans ($000)	
	1979	*1978*
Company-administered plans for salaried, nonunion, and certain union employees	$ 9,408	$ 8,558
Other union retirement and welfare plans	25,534	19,747
Total cost	$34,942	$28,305

cludes all social costs, as determined by detailed analysis of the social balance between the firm and society.

3. Where social costs are found in areas where no objective standards for their correction yet exists, the managers should strive for a correction based on standards that, in their judgment, ought to exist and should simultaneously encourage the individual involvement of the firm's members in developing the necessary social standards.
4. Where competitive pressure or economic necessity precludes socially responsible actions, the business should recognize that its operation is depleting social capital and, therefore, represents a loss. It should attempt to restore profitable operation through either better management, if the problem is internal, or by advocating corrective legislation, if

strategy in action, 3-2
Social Responsibility Report of Diamond Shamrock 1980 Annual Report

Concern for the safety and well-being of our employees and those communities in which we operate is an integral part of Diamond Shamrock's management philosophy. These concerns are translated into company policies, procedures, and programs, from planning and research to the production sale, and distribution of our products.

Safety, health, and the environment

It is the policy of Diamond Shamrock to manufacture and market our products with care, exercising regard for potential hazards involved in their use and handling by our employees, customers, and the public in general.

During 1980, Diamond Shamrock improved its plant safety record for the 10th consecutive year. Thirty plants and facilities operated without a lost-time accident. Company-wide, lost-time injuries were reduced 21 percent from 1979.

The company's highly trained staff of environmental specialists continues to establish an admirable record of meeting or exceeding standards established by local, state, and national regulatory agencies. Diamond Shamrock invested more than $19 million in new and replacement environmental equipment during 1980.

The company constantly reviews ongoing medical and industrial hygiene programs to provide the safest possible work environment for our employees. To that end, annual physical examinations are given to compare employee health data with product and plant characteristics. These studies help identify needs for introducing new safety equipment, plant engineering changes, or product handling procedures. Employees further benefit from the examinations by receiving valuable personal health data and medical consultation at no cost to themselves.

Diamond Shamrock administered 4,626 such extensive physical examinations in 1980. These served as an integral part of Diamond Shamrock's computer operated health and environmental surveillance system (COHESS). Developed at a cost of more than $2 million, COHESS is designed to compare workplace exposure, employee characteristics, and the results of physical examinations to help assure that our industrial hygiene programs are effective and to identify unknown risks as quickly as possible. COHESS represents an innovative approach by Diamond Shamrock to employee health surveillance. The company has made the program available to other corporations at reasonable cost.

strategy in action, 3–2 ***(continued)***

In addition to our worker health and environmental control programs, Diamond Shamrock invested more than $4.1 million during 1980 to determine the potential health and environmental effects of our products and to communicate that information to employees and customers. The company not only participates actively in industry-wide studies of its products but, through multidisciplinary functions, conducts extensive in-house toxicological and environmental studies through its research center and its health and environmental affairs department. Through their combined efforts, Diamond Shamrock strives constantly to prevent illness or injury to people and the environment from the use, transportation, storage, or disposal of our products.

Human resources

During the past year, Diamond Shamrock's employees continued to make substantial contributions to the success of the corporation.

Company-sponsored employee development spending exceeded $800,000 in 1980, with more than 1,500 individuals attending Diamond Shamrock training programs. These continuing programs have resulted in improved job performance, and have assisted employees in achieving individual career goals.

Diamond Shamrock actively pursues equal opportunity, without regard to religion, race, or sex; it has employment, upward mobility, and vendor programs. In addition, the company participates in and supports programs for the handicapped, Vietnam era veterans, women, and minority students.

Diamond Shamrock's compensation and benefit programs are designed to be not only competitive with the best of our peer companies but to provide an environment that fosters and gives recognition to excellence. Individual employee compensation is based on performance measured against job goals mutually selected by employee and immediate supervisor.

Public affairs

Diamond Shamrock maintains a responsive attitude to the needs of those communities in which we operate and considers this an important management responsibility. Several community relations programs assisted us in addressing these concerns during 1980.

The company invested $1,289,005 in philanthropic funds to support public, nonprofit organizations addressing needs of critical importance to the company, our employees, shareholders, and individual communities in 1980, a 26 percent increase from 1979. Plans call for $1,409,000 in philanthropic spending in 1981.

Of the 1980 total, 70 percent of our grants were directed toward higher

strategy in action, 3–2 ***(concluded)***

education and federated campaigns (United Way) supporting local health and welfare programs. The remaining 30 percent represented grants in support of local civic, cultural, and human service endeavors which address significant community needs and fulfill the criteria of our corporate contributions policy.

Diamond Shamrock encourages its employees to become involved in community affairs. Through our Citizen-of-the-Year program inaugurated in 1980, the company provides recognition for those employees who unselfishly invest personal time and expense for the betterment of their communities. Last year, 40 employees were recognized for their outstanding service to others.

Diamond Shamrock management also plays an important role in other local, state, and national affairs through advice and counsel offered to planning and zoning commissions, cooperation with various regulatory agencies, testimony before congressional review and policy-making committees, and regional task forces addressing significant social challenges.

society is suffering as a result of the way that the rules for business competition have been made.[7]

Summary

A statement of company mission defines the fundamental, unique purpose that sets a business apart from other firms of its type and identifies the scope of its operations in product and market terms. Elements of a company mission ideally include the basic type of product or service to be offered, the primary markets or customer groups whose needs will be served, the technology to be used in the production or delivery of the product or service, the fundamental concern for survival through growth and profitability, the managerial philosophy of the firm, the public image that is sought, and the self-concept which the people affiliated with the company should have of the firm.

Strategic managers developed a more comprehensive and better coordinated approach to long-term company decision making simply through the process of defining the company mission. Even more substantial benefits are derived when the mission statement is circulated among interested insider and outsider groups.

A large number of groups and individuals are keenly interested in the strategic actions taken by a firm as directed by its company mission. Executive officers of the business, its board of directors, it stockholders, and its

[7] G. E. Sawyer, *Business and Society: Managing Corporate Social Impact* (Boston: Houghton Mifflin, 1979), p. 401.

employees—in total called the insiders—are principally concerned with the achievement of the firm's mission. Customers, suppliers, governments, unions, competitors, local committees, and the general public—often called outsiders—tend to be more concerned with a much wider set of issues usually aggregated under the generic term of social responsibility. As a result of the somewhat inevitable inconsistencies between the claims of insiders and outsiders on the business, a principal task of strategic managers is the constructive handling of claimant demands. This task requires skill and ability in an identification of claimants; an understanding, reconciliation, and prioritization of their claims; and the coordination of their claims with other elements of the mission.

A company's sense of social responsibility is first revealed in its mission statement. When social responsibility is viewed from a claimant perspective, it becomes evident that strategic managers must define their company missions in ways that recognize the legitimate demands of outsiders. Simultaneously, they must perserve and protect the essential claims of insiders which are satisfied through the survival, growth, and profitability of the firm.

Questions for discussion

1. Reread the mission statement of the Zale Corporation in Figure 3-1. List five insights which you feel that you have gained of the company as a result of knowing its mission.
2. Locate the mission statement of a company not mentioned in the chapter. Where did you find it? Was it presented as a consolidated statement or were you forced to assemble it yourself from various publications of the firm? How many of the elements of a mission statement, as outlined in the chapter, did you find discussed or revealed in your company's mission?
3. Prepare a one- or two-page, typewritten mission statement for your school of business or for a company selected by your instructor.
4. List five potential vulnerabilities of a business without a stated company mission.
5. The social audit shown in Strategy in Action 3-1 included only a few of the possible indicators of a firm's social responsibility performance. Name five additional potentially valuable indicators and describe how company performance could be measured.
6. Define the term *social responsibility*. Through a library search find an example of a company action which was legal but not socially responsible. Defend your example on the basis of your definition.

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chapter 3 cohesion case

The company mission at Holiday Inns, Inc.

Chapter 3 has discussed what is necessary for a good mission statement. This Cohesion Case will first present mission statements of Holiday Inns, Inc., at the corporate and business levels. Afterwards, we will offer a brief evaluation of the mission statements and examine how these must be re-addressed as you move through the strategic management process at Holiday Inns, Inc.

Several observations can be made about Holiday Inns' mission statements. The corporate mission statement gives a clear overview of products and services offered, primary customer attributes, fundamental concerns, and basic management philosophy. The corporate mission statement places heavy emphasis on the hospitality side of the enterprise when identifying its technology for providing goods and services. This may reflect a lack of in-depth consideration about how parts of the product and transportation businesses fit into the overall corporate mission. The business group missions adequately identify the product/market scope of each unit's operations and fit within the umbrella of the corporate mission with the one exception noted above.

While these mission statements appear adequate and useful, there is an underlying mission-related issue you must consider as you move through the

exhibit 1
Holiday Inns, Inc., mission statements*

Corporate mission

Holiday Inns Inc is a diversified international corporation providing services in the lodging, food service, entertainment, and transportation industries Hotel operations consist of both company-managed and franchised Holiday Inn hotels Transportation operations include Trailways, Inc the nation's second largest intercity busline, and Delta Steamship Lines Inc, a major U S - flag shipping company Various product operations market institutional furnishings, design services, equipment and supplies

Basic to almost everything Holiday Inns, Inc does is its interaction with its market the consumer and its consistent capacity to provide what the consumer wants when and where it is needed

We are committed to leadership in marketing our products and services to the traveling and leisure-time public Internal growth of our operations will continue to be emphasized We are also closely monitoring changes in consumer needs and lifestyles so that we can develop or acquire new services to satisfy emerging trends Pursuing these opportunities will supplement the growth that we anticipate from our existing lines of business

Five basic tenets form our corporate philosophy They are

1 Maintain high ethical standards
2 Provide above-average growth in earnings
3 Improve our return on invested capital (ROIC)
4 Maintain a strong balance sheet through prudent financial management
5 People are our greatest asset deserving careful selection training and motivation

Hotel group mission

The hotel group is commited to maintaining and expanding HI's leadership position in the lodging industry by staying ahead of its competitors in responding to the ever-changing needs of the traveling consumer Through our company-owned and extensive franchise network, HI will offer moderately priced, full-service facilities in a manner that gives the customer the best price/value in the industry, provides for a superior return on stockholders' equity and meets our social responsibilities to the communities in which we operate

Product group mission

The products group is designed to fulfill the needs of HI hotels and restaurants, as well as other lodging and restaurant facilities, for nonfood products and services through three business operations Inn Keepers Supply (IKS), Innkare, and Dohrmann As an integral part of the HI system, IKS should provide a total capabilities program including design, engineering, and architecture, as well as furniture, fixtures, and equipment to support hotel development and modernization projects But many supplies are expendable and need to be replaced daily and weekly To fulfill this need, the company in 1969 created Innkare to provide a nationwide, one-stop, independent master distribution system for expendable supplies and equipment used within the hotels both Holiday Inn and otherwise And to focus its attention upon the restaurant side of the business, the company in 1970 acquired and is developing Dohrmann as a major distributor of restaurant equipment and supplies

Transportation group mission

To provide a solid profitable base for corporate diversification into travel-related areas Trailways To position HI as a market leader in providing innovative solutions to transportation (bus) industry problems through quality terminal facilities, better equipment utilization, and reversing the industry decline in passenger miles Delta Steamships Delta is committed to becoming the leading U S -flag cargo carrier between U S ports and the growing markets of South America, West Africa, and the Caribbean through cost-effective management practices and state-of-the-art technology in cargo vessels

New developments group mission

To build a broader base for future corporate earnings through diversification into hospitality-related businesses with exceptional growth potential The customer profiles as well as the necessary operating expertise of these businesses should overlap HI's core capabilities in the food and lodging area Primary focus in the near future should be on the casino/hotel business and the freestanding restaurant business

* Adopted from Holiday Inn's annual reports, 1977, 1978.

strategic management process at Holiday Inns. That issue, the fundamental purpose of defining company mission, is "what businesses are (or should) Holiday Inns be in?" From its beginning in 1954 until the early 1970s, Holiday Inns was in one business—full-service lodging facilities. Seeking a broader earnings base, Kemmons Wilson and senior management redefined its business as being a travel and transportation-related business. This definition is strongly reflected in the current corporate mission statement. That definition led to the Trailways and Delta Steamship acquisitions as well as a dual focus (outside as well as inside) in the products group.

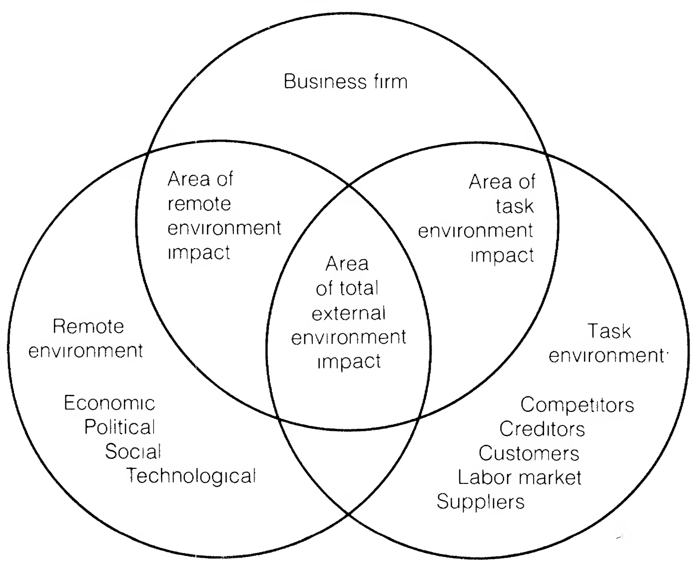
The company mission should provide long-term direction, but that does not mean it should be cast in stone. As the strategic management model indicated in Chapter 2, it must be reconsidered in light of environmental analysis, the company profile, and the evaluation of alternative strategies. Thus, the underlying, mission-related issue of whether Holiday Inns should be in the travel and transportation-related business, the travel-related business, or the hospitality-related business cannot be resolved until you begin to evaluate alternative strategies.

chapter 4

Assessing the external environment

A host of external and often largely uncontrollable factors influence the firm's choice of directions and actions and, ultimately, its organizational structure and internal processes. These factors constitute the external environment of a business. They can be segmented into two interrelated subsets of elements, those in the remote environment and those in the more immediately impinging task environment. In this chapter, the aim will be to help you to better understand the complexities and necessities involved in formulating strategies which optimize a firm's opportunities in the highly competitive market operating within the overall business environment (see Figure 4–1).

figure 4–1
The firm's external environment



Remote environment[1]

The remote environment is composed of a set of forces which originate beyond and usually irrespective of any single firm's operating situation. Encompassing political, economic, social, and technological factors, the remote environment presents opportunities, threats, and constraints for the firm, with the organization rarely possessing the strength to exert any meaningful reciprocal influence. For example, when the economy slows and recession is threatening, an individual housing contractor is likely to suffer a decline in business consistent with an industry-wide decrease in construction starts. Yet, that same contractor would be unable to reverse the nation's negative economic trend despite any individual success which he might have in stimulating additional local building activity. For a second example, evidence of political forces is seen in the trade agreements resulting from the improved relations between America and China in the mid-1970s. These agreements provided otherwise unavailable opportunities for individual business in the U.S. electronics manufacturing industry to broaden their international bases of operation.

Economic considerations

Economic considerations refer to the nature and direction of the economy in which business operates. Since consumption patterns are largely affected by the relative affluence of various market segments of the population, it is essential that each firm understand the economic trends of the societies which affect its industry. On both national and international levels, a firm must consider the general availability of credit, the level of disposable income, and the propensity of people to spend. Prime interest rates, rates of inflation, and growth trends of the gross national product are additional economic conditions which must be carefully considered during the strategic planning process.

Until recently, the potential for economic impact of international forces appeared severely restricted and was largely discounted. However, the emergence of new international power brokers has changed the focus of economic environmental forecasting. Three prominent examples of newly influential powers are the European Economic Community (EEC), the Organization of Petroleum Exporting Countries (OPEC), and coalitions of lesser developed countries (LDC).

The EEC or Common Market was established by the Treaty of Rome in 1957, and its members include most of the countries of western Europe. Its purpose is the elimination of quotas and the establishment of a tariff-free area for industrial products. This unique example of intra-European cooperation has helped these countries compete more effectively on international

[1] Portions of this chapter are adapted from John A. Pearce II and Richard B. Robinson, Jr., "Strategic Forecast Management," *Business*, July-September 1982.

world markets. Following the EEC precedent of economic cooperation, the United States, Canada, Japan, the EEC, and other countries conducted the multilateral trade negotiations in 1979 to establish rules for international trade cooperation and conduct. The consequences of those negotiations profoundly, yet differentially, affect almost every aspect of business activity in the United States.

Among the international economic forces, OPEC is the most powerful one in existence today in terms of its impact on the United States. OPEC is an oil cartel which includes most major world suppliers of oil and gas. Its drastic increases in the price of energy supplies to the United States impeded America's recovery from the recession of the early 1970s and fueled inflationary fires the world over. The automobile industry in America was particularly affected through the increase in user costs and the legislated redesign of engine sizes and performance standards.

The Third World and Fourth World countries have recently assumed a greater role in international commerce, as a source of both threats and opportunities. Following the success of OPEC, the LDCs have found it economically beneficial to directly confront the established powers. Since 1974, producers of primary commodities in the LDCs have formed or greatly strengthened their trade organizations in order to enforce higher prices and to achieve larger real incomes for their members. On the other hand, developing countries offer U.S. firms huge new markets for foodstuffs and capital machinery.

Even countries not desiring or unable to form cartels exhibit the new aggressive attitude.

> The intense nationalism of the developing countries, with nearly three fourths of the world's population, represents perhaps the greatest challenge our industrialized society and multinational corporations will face in the next two decades. As one Third World expert puts it . . . "the vastly unequal relationship between the rich and poor nations is fast becoming the central issue of our time."[2]

Each of these international forces have the capacity to affect the economic well-being of the U.S. business community—for better or worse, for richer or poorer. Consequently, companies must attempt to anticipate major repercussions from actions taken both within the domestic and international economic arenas. Such forecasts thereby become a critical part of the strategic planning process.

Social considerations

Social considerations refer to the beliefs, values, attitudes, opinions, and lifestyles of the members of the firm's external environment, as developed

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[2] Richard Steade, "Multinational Corporations and the Changing World Economic Order," *California Management Review*, Winter 1978, p. 5.

from their cultural, ecological, demographic, religious, educational, and ethnic conditioning. As social attitudes change so do the demands for variour clothing styles, books, leisure activities, and other products and services. Like the other forces in the remote external environment, social forces are dynamic. Their constant change results from the efforts of people to control and adapt to the other environmental factors in order to satisfy their desires and needs.

One of the most profound social changes in recent years has been the tremendously large number of women who have entered the employed labor market. Not only have these women changed hiring and compensation policies and resource capabilities of their firms, they have also created or greatly expanded the demand for a wide range of products and services as a result of their absence from their homes. Businesses which correctly anticipated or quickly reacted to this social change have profited by offering such products and services as convenience foods, microwave ovens, and children day-care centers for two-career families.

A second accelerating social change is the interest of consumers and employees in quality of life issues, even at the expense of greater economic affluence. Evidence of the change has been displayed in recent worker-management contract bargaining. Added to the traditional demands for increased salaries have been worker preferences for such self-rejuvenating benefits as sabbatical leaves for travel, flexible hours or four-day work weeks, lump-sum vacation plans, and opportunities for advanced training.

A third important change in the social environment for business has been the shift in the national population age distribution. Changing social values and increased acceptance of improved birth control methods have resulted in a rise in the mean age of the population in the United States from 27.9 in 1970 to an expected 34.9 years by the turn of the century. This trend will have an increasingly unfavorable impact on the majority of predominating youth-oriented producers of goods and will necessitate a shift in long-range marketing strategies. For example, producers of hair care and skin creme products have already begun to adjust their research and development priorities to reflect anticipated changes in the types of products which will be demanded. One company which has recognized the impact potential of the population change is Procter & Gamble whose reaction is discussed in Strategy in Action 4–1.

One consequence of a changing population distribution is found in the sharply increased demands of an enlarging senior citizen population. Constrained by fixed incomes in face of rising inflation, the elderly have demanded that arbitrary and rigid policies on retirement age be modified. They have successfully lobbied for tax exemptions and social security benefit increases. Such changes have significantly altered the opportunity-risk equations of many firms—often much to the benefit of those businesses which responded in anticipation of the societal impacts.

Translating social change into forecasts of business effects is a difficult

process at best. Nevertheless, informed estimates of the impact of such alterations in the social environment as geographic shifting of populations, changing work and ethical values, and religious orientations can only help a strategizing firm in its attempts to prosper.

Political considerations

The direction and stability of the political factor constitutes a major consideration for managers in formulating company strategy by defining the legal and otherwise governing parameters in which the firm must or may wish to operate. Constraints are placed on each company through fair trade decisions, antitrust laws, tax programs, minimum wage legislation, pollution and pricing policies, administrative jawboning, and many other actions aimed at protecting the consumer and the environment. These laws, practices, and regulations are most commonly restrictive in nature; and as a result, they tend to reduce potential profits of the firm. However, other politically based actions are designed to benefit and protect the company. Examples of probusiness activities include patent laws, government subsidies, and product research grants. Thus, the restrictions imposed through the political force both limit and benefit the firms under their influence.

In addition to its effect on legislative decisions, political activity also impacts heavily on three additional governmental functions which affect a firm's remote environment:

1. *Supplier function.* The government's disposition regarding the creation and accessibility which private businesses will have to government-owned natural resources and national stockpiles of agricultural products will profoundly affect the viability of alternative strategies of selected firms.

2. *Customer function.* The demand which government makes for products and services can create, sustain, enhance, or eliminate many market opportunities. For example, in the same way that the Kennedy administration's emphasis on landing a man on the moon spawned the demand for literally thousands of new products in the 1960s, the Carter administration's emphasis on developing synthetic fuels may create a similar demand for new skills, technologies, and products in the 1980s. If the efforts are successful, the synthetic fuels industry will be brought from infancy to maturity in a decade.

3. *Competitor function.* The government can operate as an almost unbeatable competitor in the marketplace. Thus, knowledge of its strategies gained from an assessment of the remote environment can help a firm to avoid unfavorable confrontation with government as a competitor. For example, forecasted decisions of government to increase the number of nuclear power plants or communication facilities might simultaneously serve as retreat signals to direct private competitors and invitations to private producers or services of associated activities.

strategy in action, 4–1

Procter & Gamble

Procter & Gamble Co. announced a new product on August 7, 1979, symbolizing a revolutionary era at the big Cincinnati company. The product was a medicinal cream for the treatment of skin lesions. Procter & Gamble had just begun the implementation of a grand invasion of new markets, many of which were institutional and commercial fields well outside of its traditional haven in the nation's supermarkets. The first phalanx of these new products from Procter called for fanning out into such fields as prescription drugs, synthetic foods and food ingredients, and supplies for hospitals and nursing homes. Others, destined for the soft drink and agriculture-chemicals markets, were lying in wait. These non-supermarket offerings were forecasted to account for as much as 20 percent of the company's business by the mid-80s.

The broad intent of this strategy was clear. With birthrates declining and population growth leveling off, the demographic trends that fueled P&G's ascent over the decades of the 1960s and 1970s were reversing. Given this shift, the company decided to look elsewhere to continue expanding at their previous rate.

The diversification drive also involved huge, unexplored risks. In many of its new fields, such as drugs and chemicals, the company had to take on formidable competitors that were not much impressed by P&G's recognized preeminence in packaged goods. Although the company boasted an unequaled marketing network for consumer products, many rivals doubted its ability to sell to institutions, doctors, and pharmacists.

Still, P&G had clearly decided that the competitive risks did not outweigh the potential rewards of its new-product campaign, nor did they eclipse the company's need to find new avenues of growth.

Source: Based on the article "P&G's New New-Product Onslaught," from the October 1, 1979 issue of *Business Week*.

Businesses are strongly affected by government decisions, as is shown in Strategy in Action 4–2. Thus, the continual assessment of government strategizing will aid individual firms in their own development of complementary plans to anticipate and optimize available environmental opportunities.

Technological considerations

The final set of considerations in the remote environment of business are technological advancements. A firm must be aware of technological changes

that might affect its industry in order to resist obsolescence and promote innovation. Creative technological adaptations can impact the planning of a business by suggesting new products or improving existing ones, and by improving the processes by which products are made and marketed.

strategy in action, 4–2
A Major Threat in the CPA Firm's Environment

"These are our own ideas and opinions, our private notes," says Robert Hermann, a tax manager with the accounting firm of Deloitte Haskins & Sells. "They are none of the IRS's business."

The Internal Revenue Service disagrees, however, and the result is a bitter controversy.

The notes in question are those in which auditors spell out any doubts they have about a client's tax position. Accountants have always considered these confidential. But now, they say, recent IRS aggressivness in seeking these papers has undermined their relationships with their corporate clients, and has threatened to damage the quality of financial reports.

"The impact on the audit process has been substantial," says William Raby, a partner in Touche Ross & Co. "We've seen a drying up of the willingness of clients to discuss or even show data to their auditors. And the bottom line is that it isn't leading to good financial reporting."

When preparing and auditing financial statements, accountants include a reserve for taxes that might be payable if the IRS investigates. A company may take an investment tax credit, for instance, although it realizes that the IRS could disagree. Its memos, and those of its auditors, would spell out the arguments on each side.

But the tax credit likely would be just one of many such items, and the IRS typically sees only the grand total reserve. If it had access to the internal documents, it could see a breakdown of all the uncertain areas.

"It's a trail to the sensitive issues on the tax return," says William T. Holloran, a New York City lawyer and accountant. He says accountants try to dream up the worst possible scenarios, but "if the IRS sees that you wondered about something, they may just say, 'Gee, there must be something wrong with it.'"

Until recently, accountants say, the IRS rarely asked for such papers. Then, in June of 1979, the department revised the field manual used by agents.

"Up to then, there was no directive to the field agents to ask the corporations to volunteer information, and no written directives to ask accountants for the information," says David Buchholz, managing director, tax policy and procedure, at Arthur Andersen & Co. in Chicago.

Buchholz says requests for the documents have increased since June. He says Arthur Andersen negotiates with the IRS when possible, and that the government has taken a go-slow approach when it comes to forcing auditors to hand over documents. But he says the real damage has come from companies anticipating requests.

"Every major corporation, faced with the thought that their auditors will have to make disclosures that they didn't have to in the past, is positioning itself to defend its privacy," he says. He explains that clients have told Arthur Andersen that they can't discuss certain sensitive areas anymore.

The IRS denies that its requests damage the auditor-client relationship. Furthermore, an IRS official says, "We feel that the information might throw light on the correctness of a taxpayer return." He says the memos are necessary because corporations usually are more open with accountants than with the government, "and we can't stay with a company for an unlimited period of time" ferreting out information. "The tax system shouldn't be viewed as a game of hide and seek. If we can get the papers, we can make a determination (of tax liability) much quicker, and not waste the taxpayers' money."

Some companies say their lawyers have advised them to discuss potential tax liability with an attorney: communication between the corporation and the lawyer might then be protected as privileged. Accountants contend that lawyers are stealing their business. Besides, they add, auditors still will have to judge the soundness of financial statements.

Most experts say that the only answer may rest with the IRS. "We can only hope that the IRS won't go bananas in this area," says Holloran, the New York City lawyer and accountant. "On a normal audit, they have to show restraint."

Source: "Auditors Say IRS Demand for Documents Is Poisoning Relations with Client Firms," *The Wall Street Journal*, January 15, 1981.

A technological innovation can have a sudden and dramatic effect upon the environment of a business firm. A breakthrough can spawn sophisticated new markets and products or significantly shorten the anticipated life of a manufacturing facility. Thus, all firms, and most particularly those in turbulent growth industries, must strive for a clear understanding of both the present state of technological advancements affecting its products and services and of the more probable future innovations. This quasi science of attempting to foresee technological advancements and to estimate their probable impact on an organization's operations is known as technological forecasting.

Technological forecasting is a proven aid in protecting and improving the

profitability of firms in growing industries. It alerts strategic managers to both impending challenges and promising opportunities. To cite two examples: (1) Advances in xerography were a key to Xerox success, but caused major difficulties for carbon paper manufacturers; and (2) the perfection of transistors changed the nature of competition in the radio and television industry, helping giants like RCA while seriously weakening smaller firms whose resource commitments required that their products continue to be based on vacuum tube performance.

The key to beneficial forecasting of technological advancement lies both in accurately predicting future capabilities and also probable future impacts. A comprehensive analysis of the impact of change brought about by technological advancements involves the study of expected effects of new technologies on the remote environment, the competitive business situation, and the business-society interface. In recent years, forecasting in the area of the business-society interface has warranted particular attention. For example, as a consequence of increased environmental sensitivity, businesses must carefully investigate the probable impact of technological advances on quality of life factors such as ecology, aesthetics, and public safety.

Task environment

The concept of the task environment refers to the factors in the immediate competitive situation which provide many of the challenges that a particular firm faces when attempting to attract or acquire needed resources or when striving to market its goods and services in a profitable manner. Among the most prominent of these factors are a firm's competitive position, customer profile, reputation among suppliers and creditors, and the accessible labor market. The task environment, which is alternatively called the competitive or operating environment, differs from the remote environment in that it is typically subject to a much greater degree of influence or control by the firm. Thus, individual businesses can be much more proactive in their strategic planning when they incorporate consideration of the conditions in the task environment, than they can when only remote factors are studied.

Competitive position

Through an assessment of its competitive position a business improves its chances of designing strategies to optimize the environmental opportunities. The development of competitor profiles enables a firm to more accurately forecast both its short- and long-term growth and profit potentials.

Although the exact evaluative criteria to be used in constructing a competitor's profile are largely determined by situational factors in the environment, the following criteria are often included:

1. Market share.
2. Breadth of product line.
3. Sales distribution effectiveness.
4. Proprietary and key account advantages.
5. Price competitiveness.
6. Advertising and promotion effectiveness.
7. Facility location and newness.
8. Capacity and productivity.
9. Place on the experience curve.
10. Raw material costs.
11. Financial position.
12. Relative product quality.
13. R & D advantages/position.
14. Caliber of personnel.
15. General image.[3]

Once the appropriate criteria have been selected, they are subjectively weighted to reflect their relative importance to the success of a firm. Next, the competitor under evaluation is rated on the criteria. By multiplying the weightings by the rankings and summing the resulting weighted scores, a numerical profile is made of the competing business, as shown in Figure 4–2.

figure 4–2
Competitor profile

Key success factors	*Weight*	*Rating*†	*Weighted score*
Market share	.30	4	1.20
Price competitiveness	.20	3	.60
Facilities location	.20	5	1.00
Raw materials cost	.10	3	.30
Caliber of personnel	.20	1	.20
	1.00*		3.30

* The total of the weights must always equal 1.00.
† The rating scale suggested is as follows: very strong competitive position (5 points), strong (4), average (3), weak (2), very weak (1).

The type of competitor profiling suggested above is limited in its value by the subjective nature of the criteria selection, weighting, and evaluation approaches employed. Nevertheless, this process is of considerable value in helping a business to explicitly define its self-perception of competitive position. When self and competitor profiles are compared they can further aid the business manager in an identification of specific factors which are likely

[3] These items were selected from a competitive position assessment matrix proposed by Charles W. Hofer and Dan Schendel, *Strategy Formulation: Analytical Concepts* (St. Paul: West Publishing, 1978), p. 76.

to contribute to a competitor's vulnerability to alternative strategies which the firm might choose to implement.

Customer profiles

Achieving an understanding of the composition of its customers is perhaps the firm's most valuable result of conducting an analysis of the task environment. By developing a customer profile of present and prospective buyers, managers are better able to plan the strategic operations of the firm. They are better able to anticipate changes in the size of markets and to allocate resources in support of forecasted shifts in consumer demand patterns.

Four principal types of information are useful in constructing a customer profile: geographic, demographic, psychographic, and buyer behavior (see Figure 4–3).

It is important to understand the boundaries of the geographic area from which customers do or could come. Almost every product and service market exhibits some geographic quality which makes it variably attractive to buyers from different locations. Obviously, a successful regional manufacturer of snow skis in Wisconsin should think twice about investing in a wholesale distribution center in South Carolina. On the other hand, advertising by a major Myrtle Beach (South Carolina) hotel in the *Milwaukee Sun-Times* could significantly expand the hotel's geographically defined customer market.

Demographic variables are the most commonly used factors for differentiating among groups of individual customers. The term *demographic* refers to a descriptive characteristic which can be used in the identcfication of present or potential customers. Demographic information such as sex, age, marital status, income, and occupation is comparatively easy to collect, quantify, and use in strategic forecasting, and it represents the minimum of data which will constitute the basis of a customer profile.

It is often the case that customer personality and lifestyle are better predictors of purchase behavior than geographic or demographic variables. In such situations, a psychographic study of customers is an important component of the total profile. Recent soft-drink advertising campaigns by Pepsi-Cola (The Pepsi Generation) and 7-up (America's Turning 7-up) reflect strategic management's attention not only to demographics but also to the psychographic characteristics of their largest customer segment—physically active, group oriented, nonprofessionals.

A final type of information which can be used in constructing a customer profile is buyer-behavior data. This information reflects a multifaceted set of factors used to explain or predict some aspect of customers' behavior with regard to a product or service. As shown in Figure 4–3, information gathered by a business about buyer-behavior factors such as usage rate, benefits

figure 4-3
Customer profile considerations

Type of information	*Typical breakdowns*
Geographic:	
Region	Pacific; Mountain; West North Central; West South Central; East North Central; East South Central; South Atlantic; Middle Atlantic; New England
County size	A; B; C; D
City or SMSA size*	Under 5,000; 5,000-19,999; 20,000-49,999; 50,000-99,000; 100,000-249,999; 250,000-499,999; 500,000-999,999; 1,000,000-3,999,999; 4 million or over
Density	Urban; suburban; rural
Climate	Northern; southern
Demographic:	
Age	Under 6; 6–11; 12–17; 18–34; 35–49; 50–64; 65+
Sex	Male; female
Family size	1–2; 3–4; 5+
Family life cycle	Young, single; young, married, no children; young, married, youngest child under six; young, married, youngest child six or over; older, married, with children; older, married, no children under 18; older, single; other
Income	Under \$5,000; \$5,000-\$7,999; \$8,000-\$9,999; over \$10,000
Occupation	Professional and technical; managers, officials and proprietors; clerical, sales; craftsmen, foremen; operatives; farmers; retired; students, housewives; unemployed
Education	Grade school or less; some high school; graduated high school; some college; graduated college
Religion	Catholic; Protestant; Jewish; other
Race	White; Negro; Oriental
Nationality	American; British; French; German; Eastern European; Scandinavian; Italian; Spanish; Latin American; Middle Eastern; Japanese; and so on
Social class	Lower-lower; upper-lower; lower-middle; middle-middle; upper-middle; lower-upper; upper-upper
Psychographic:	
Compulsiveness	Compulsive; noncompulsive
Gregariousness	Extrovert; introvert
Autonomy	Dependent; independent
Conservatism	Conservative; liberal; radical
Authoritarianism	Authoritarin; democratic
Leadership	Leader; follower
Ambitiousness	High achiever; low achiever
Buyer Behavior:	
Usage rate	Nonuser; light user; medium user; heavy user
Readiness stage	Unaware; aware, interested; intending to try; trier; regular buyer
Benefits sought	Economy; status; dependability
End use	Varies with the product
Brand loyalty	None; light; strong
Marketing-factor sensibility	Quality; price; service; advertising; sales promotion

* SMSA stands for standard metropolitan statistical area.
Source: Adapted from Philip Kotler, *Market Management* (Englewood Cliffs, N.J.: Prentice-Hall, 1972), p. 170.

sought, and brand loyalty can aid significantly in the design of strategies which are more accurately and more profitably targeted.

Suppliers and creditors: Sources of resources

Dependable relationships between a business firm and its suppliers and creditors are essential to the company's long-term survival and growth. A firm relies on its sources of resources for financial support, services, materials, and equipment on a regular basis. Additionally, a business is occasionally forced to make special requests of its creditors and suppliers for such favors as quick delivery, liberal credit terms, or broken-lot orders. Particularly during these times, it is essential that a business has developed an enduring relationship with its sources of resources.

In addition to the issue of the strength of a firm's relationships to suppliers and creditors, several other factors should be considered in an assessment of this aspect of the task environment. With regard to its competitive position with its suppliers, a firm should address the following questions.

1. Are its suppliers' prices competitive? Do they offer attractive quantity price discounts? How costly are their shipping charges?
2. Are its vendors' quality ratings competitive? In terms of production standards? In terms of deficiency rates?
3. Are its suppliers' abilities, reputation, and services competitive?
4. Are its suppliers reciprocally dependent on the firm?

With regard to its competitive position with its creditors, the following questions are among the most important for the strategizing firm.

1. Is its stock fairly valued and willingly accepted as collateral?
2. Do its potential creditors perceive the firm to have an acceptable record of past payment? A strong working capital position? Little or no leverage?
3. Are its creditors' current loan terms compatible with the firm's profitability objectives?
4. Are its creditors able to extend the necessary line of credit?

Answers to these and related questions help a business to forecast the availability of the resources which it will need to acquire in order to implement and sustain its competitive strategies. Since financial, human, and material resources are rarely available with ideal quantity, quality, price, and accessibility characteristics, the assessment of suppliers and creditors is critical to an accurate assessment of a firm's task environment.

Personnel: Nature of the labor market

The ability to attract and hold capable employees is a prerequisite requirement for a successful firm. However, it is often the nature of a business's

task environment which most influences its personnel recruitment and selection alternatives.

Three factors which most affect a firm's access to needed personnel are the reputation of the business as an employer, the local employment rates, and the ready availability of needed knowledge and skills.

A business's reputation within the task environment is a major element in its long-term ability to satisfy its personnel needs. A firm which is seen as permanent in the community, is at least competitive in its compensation package, is concerned with employee welfare, is respected for its product or service, and is appreciated for its overall contribution to the general welfare is more likely to attract and retain valuable employees than is a rival firm which either exhibits fewer of these qualities or which emphasizes one factor to the detriment of others.

Depending principally on a business community's growth stage, the readily available supply of skilled and experienced personnel may vary considerably. A new manufacturing firm seeking skilled employees in a vigorous and established industrialized community obviously faces a more difficult problem than would the same firm if it were to locate in an economically depressed area where other similar firms had recently cut back operations.

Some people's skills are so specialized that they may be forced to relocate in order to secure appropriate jobs and the impressive compensations which their skills commonly command, e.g., oil drillers, recognized chefs, technical specialists, and industry executives. A firm seeking to hire such an individual is said to have broad labor market boundaries. That is, the geographic area within which the firm might reasonably expect to be able to attract qualified candidates is quite large. On the other hand, it is much less likely that an individual with more commonly available skills would be willing to relocate from considerable distance in order to achieve modest economic or career advancement. Thus, the labor market boundaries are fairly limited for such occupational groups as unskilled laborers, clerical personnel, and retail clerks.

Emphasis on environmental factors

This chapter has pictured the remote environment as encompassing four components: economic, political, social, and technological. The task environment was discussed as a set of five factors: competitors, creditors, customers, labor markets, and suppliers. While this approach is generally accurate, it may give the false impression that these components and factors are easily identified, mutually exclusive, and equally applicable in all situations. In fact, the forces in the external environment are so dynamic and interactive that the impact of any single element cannot be wholly dissassociated from the impact of other elements. For example, are increases in OPEC oil prices the result of economic, political, social, or technological changes? Or, is a manufacturer's surprisingly good relations with suppliers a result of

competitor's, customer's, creditor's, or the supplier's own activities? The answer to both questions is probably that a combination of forces in the external environment have combined to create the situation. Such is the case in most studies of the environment.

When strategic managers attempt to anticipate the changing influences of the environment they are frequently frustrated. Different external elements affect different strategies, at different times, with varying strengths. The only certainty is that the impact of the remote and task environment will be uncertain until a strategy is implemented. This disconcerting reality leads many managers, particularly in comparatively less powerful smaller firms, to minimize long-term planning which requires a commitment of resources in favor of increased flexibility which enables them to adapt to new pressures from the environment. While it is true that such a decision has considerable merit for many firms, the associated trade-off should be realized, namely, that the absence of a strong resource and psychological commitment to a proactive strategy effectively bars the firm from assuming a leadership role in its competitive environment.

A final difficulty in assessing the probable impact of remote and task environments on the effectiveness of alternative strategies is that of collecting information which can be analyzed to disclose predictable effects on a given firm. Except in rare instances, it is virtually impossible for any single firm to anticipate the consequences of a change in the environment on its operations. It is impossible to predict the precise effect on alternative strategies of a 2 percent increase in the national inflation rate, a 1 percent decrease in statewide unemployment, or the addition of a new competitor to regional market place.

The real advantage of assessing the potential impact of changes in the external environment lies in an increased ability of decision makers to narrow the range of available alternatives rather than to enable the selection of a maximizing strategy. Assessing the environment facilitates the elimination of options which are clearly inconsistent with forecasted opportunities. It seldom identifies the best strategy, but it characteristically leads to the elimination of all but the most promising alternatives.

Designing opportunistic strategies

The process of designing business strategies which will enable the firm to operate effectively within a characteristically dynamic external environment is multifaceted, complex, and often principally dependent on fairly subjective and intuitive impact assessments (see Strategy in Action 4–3 for an example). The process is multifaceted because the strategic decision maker must investigate independent and interactive sources of influence from both the remote and task level of the environment. Such studies must be conducted in preparation of any systematic or comprehensive strategic decision. The process is complex both because the environmental forces have indi-

vidual and interactive effects on businesses and because environmental forces have variable effects on a business depending on its unique situation. Finally, most strategies are developed from fairly subjective and intuitive impact assessments of information gathered from a study of the environment. The limited objectivity in such studies is an understandable consequence of any business's inability to rely solely on historical trends to accurately predict future events, given constant changes in the competitive external environments.

Designing a strategy to optimize opportunities suggested by an assessment of the business environment is a difficult task:

> It usually means questioning old methods, exploring unfamiliar environmental waters, facing up to an objective evaluation of strengths and weaknesses, forcing important changes on people in the firm and organizational arrangements, and taking high risks with the firm's capital. Moreover, it has to be done in a world of rapid change, and it has to be done continuously.[4]

As a result of the multifaceted, complex, and subjective nature of the corporate strategy formulation process, strategic managers should give special emphasis to three major design recommendations when developing their firm's future plans: selecting of forecasting data, conducting environmental impact studies, and planning for flexibility.

[4] George A. Steiner, *Top Management Planning* (New York: Macmillan, 1969), pp. 238–39.

strategy in action, 4-3 A Coal Industry Perspective

For the coal industry, 1979 was a bleak year. Spare capacity was as high as 20 percent, or 150 million tons. Miners were out of work, and mines were closing. Coal profits were off by more than 50 percent.

However, one segment of the industry appeared on the verge of remarkable gains—coal companies owned by oil companies. Eleven oil companies owned 25 percent of all the coal in the country in 1979, and had the future of coal in their grip. Moreover, oil companies planned to increase the 22 percent production share in 1978 to 50 percent by 1985.

In the past, during periods of slack demand, it was common for small mines to close; when prices firmed up the mines reopened. In 1978, however, the growing cost and complexity of federal regulations made many such comebacks too expensive for small mines. Approximately 1,000 companies had left the coal business since the mid-1960s—about half of them since 1977.

But if costly regulation and slack market spelled trouble to the small

mines, their impact on big companies was just the opposite. "What oil companies contribute to their coal subsidiaries is staying power," said Hiram E. Bond, president of ARCO Coal Co. In fact, there was little evidence that the industry's slump in 1978 slowed big oil's plan for coal. Most of the country's top oil companies had major coal expansion programs under way. Increasingly, oil company money, technology, and management skills set the pace for coal's growth.

One reason the oil companies were banking on coal was a firmly held belief that utilities, the major coal consumers, had little choice about the fuel they burned in new plants—it had to be coal. The companies also believed that coal would be a major beneficiary of the problems of nuclear energy.

There were some problems. These included environmental laws such as the Clean Air Act and reclamation regulations. Additionally, new coal leasing regulations on federal coal mines slowed the industry's growth. Skyrocketing transportation costs were also a factor. However, the most troubling industry problem was another touchy political issue—the growing tide of antioil industry sentiment that could lead to antitrust action against energy conglomerates.

Source: Based on the article "The Oil Majors Bet on Coal," from the September 24, 1979 issue of *Business Week*.

Much of the forecasting information used by managers in the process of designing strategies is gathered by them in the regular pursuit of their business activities, e.g., reading business and government publications, discussing competitive conditions with sales managers and clients, and serving on community councils and committees. However, such personalized data collection is subject to considerable bias in interpretation and its validity is often difficult to document and verify. Therefore, it is beneficial to systematically collect pertinent data from public sources. Such data is fairly readily available, inexpensive, and in general, comparatively reliable. Public data sources include printed materials from annual reports, business literature indices, business periodicals and reference services, government publications, trade publications, stockbroker reports, and many others. While all of these sources may be referenced to detect general environmental trends, managers must select carefully among them when constructing a strategic data base. The criteria of relevance, importance, manageability, accessibility, variability, and cost must all be considered prior to the selection or generation of the data to be used as a basis of strategic planning.

The nature and magnitude of the predicted impact of new strategic action is a second important consideration which influences the design of environmental opportunistic strategies. Following the selection of forecasting data, the business must conduct impact studies to determine the overall consequences for the firm of implementing available alternative strategies. In the process, the firm will transform environmental data into situation-specific environmental information. A typical impact study employs a systems view

in the assessment of probable effects of an available strategy on the firm's strengths and weaknesses profile, its task environment, its competitive position, and its likelihood of achieving corporate objectives, grand strategies, and mission. Although impact studies are predominately subjective and intuitive in nature, businesses attempt to develop objective estimates whenever possible. Increasingly, firms have employed such techniques as exponential smoothing, time trends, and adaptive forecasting to facilitate objectivity in data analysis.

A third important consideration in the design of strategies is the need to incorporate the quality of flexibility. Because of the uncertainty inherent in forecasting environmental conditions, strategic decision makers enhance their chances of profitability if they strive for an optimal level of flexibility in their strategic plans. Several approaches to increase such flexibility can be suggested.

1. State a strategy in general terms in order to allow implementors some discretion in light of their unique situations.
2. Review strategies frequently.
3. Treat strategies as rules with exceptions whereby implementors can violate an aspect of a strategy if they can justify their decision.
4. Keep options open.

While it must be understood that the introduction of any flexibility into a strategic plan will dilute its benefits by increasing costs, shortening planning and action horizons, and increasing internal uncertainty, an overly rigid stance in support of a particular strategy can be devastating to a firm faced with unexpected environmental turbulence.

Summary

The external environment of a business consists of two interrelated sets of variables which play a principal role in determining the firm's opportunities, threats, and constraints. The variables which originate beyond and usually irrespective of any single firm's operating situation form the remote environment which consists of political, economic, social, and technological forces. The variables which influence the immediate competitive situation of the firm constitute the task environment. Its components include a business's competitive position, customer profiles, suppliers and creditors, and the accessible labor market. These two sets of forces provide many of the challenges which a particular firm faces when attempting to attract or acquire needed resources, and when striving to market its goods and services in a profitable manner.

The process of designing corporate strategies which will enable the firm to interact effectively with a characteristically dynamic external environment is multifaceted, complex, and often principally dependent on fairly subjective and intuitive impact assessments. Nevertheless, assessments of a firm's

external environment can provide a valuable planning base, especially when three major design recommendations are followed.

1. Environmental data should be collected over a meaningfully wide range of factors. Emphasis should be placed on blending personal perceptions of strategic managers with public data sources.
2. Impact studies should be undertaken to convert the data into business relevant information to be used in helping to determine the overall consequences for the firm of implementing the available alternative strategies.
3. The selected strategy should exhibit built-in flexibility to be capable of accommodating unexpected variations in the environmental forecasts.

Thus, when designing opportunistic strategies to profitably operate within its external environment, the firm is acting on its conviction that the company which can anticipate future business conditions will improve its performance and profitability. Despite the uncertainty and dynamism of the business environment, an assessment process which narrows, if not precisely defines, future expectations is of substantive value to strategic managers.

Questions for discussion

1. Briefly describe two important recent changes in the remote external environment of U.S. business in each of the following areas:
   a. Economic.
   b. Political.
   c. Social.
   d. Technological.
2. Describe two major anticipated environmental changes which you forecast as having a major impact on the wholesale food industry during the next 10 years.
3. Develop a competitor profile for your college and the one geographically closest to it. Next, prepare a brief strategic plan to improve the competitive position of the weaker of the two schools.
4. Assume that a competitively priced synthetic fuel is invented which could supply 25 percent of the U.S. energy needs within 20 years. In what major ways might the external environment of U.S. business be changed?
5. With the help of your instructor, identify a local business which has enjoyed great growth in recent years. To what degree and in what ways do you think this firm's success resulted from taking advantage of favorable conditions in its external remote and task environments?

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chapter 4 cohesion case

Environmental assessment at Holiday Inns, Inc.

Environmental assessment at Holiday Inns, Inc. must first evaluate the remote and task environments of each business group. Afterwards, these evaluations would be compared to synthesize the environmental situation facing the overall corporate enterprise. We will briefly analyze the remote and task environments of the key business groups using a table format. To aid this analysis, a scale from +10 to −10 will be used to identify the degree to which each environmental factor represents an opportunity or threat in the business's environment.

Comparing the remote environments in Exhibit 1, Holiday Inns' most favorable opportunities appear in the three hospitality-related businesses: hotels, restaurants, and casinos. Social factors in the remote environment are strongly favorable for all three businesses. The remote environment is moderately opportunistic relative to the steamship operation, but inconsequential for the products group. The major remote environment threats appear in relation to the Trailways bus operation. Next we turn to the task environment.

Exhibit 2 examines the task environments of each business group. The

exhibit 1

Assessment of remote environment factors

Business	*Economy*	*Political*	*Social*	*Technology*
Hotels	Reduced vacation travel during recessions/energy costs (−4)	Legal challenges to franchise agreement/political stability of international locations (−2)	Increasing leisure time/older population/single travelers and smaller families/baby boom now 25–35 years old (+8)	Electronic and computer technology in reservation and control systems/satellite communication/labor saving technologies (+6)
Products group	Reduced demand during recession (−2)	? (0)	Changing preferences in furnishings (+3)	Laborsaving technology/obsolescense of current equipment lines (+1)
Trailways	Less travel during recession but bus is a low-priced alternative energy cost (+1)	Safety regulations/no government ownership of terminals/deregulation of airline industry (−5)	All of the factors in above hotel block applicable here, though considerably less beneficial (−2)	Laborsaving and cost-saving technology only minimal benefits, other transportation areas more (−3)
Delta Steamship	Recession can hurt exports and imports/energy costs (−3)	Emergence of Third World markets/U.S. subsidies of U.S.-flag carriers and low-interest loans (+5)	Increasing concern for U.S. international trade effectiveness (+1)	Laborsaving (LASH) technologies and energy-saving technologies (+3)
Freestanding restaurants	Recession doesn't hurt family restaurants/energy costs (+3)	Legal challenges to franchising (−1)	Increasing pattern of eating out/baby boom now 25–35/number of single-member households rising (+8)	Laborsaving and energy-saving improvements/food preparation technology (+4)
Casino gaming	Recessionary impact on leisure travel/energy costs (−2)	Regulation of casino gambling/limited legal gaming markets (−2)	All the factors mentioned in the hotel block above/increasing social acceptance of gaming (+8)	Similar to hotel block though with less impact (+3)

exhibit 2

Assessment of task environment factors

Business	*Competition*	*Customers*	*Labor*	*Creditors*	*Suppliers*
Hotel group	Substantial increase in the number of budget-chain competitors/no immediate threat to HI's leadership position, but gap is narrowing, especially with budget-conscious traveler (+5)	1 out of 6 American travelers stayed at HIs in 1978/research shows HI to be the preference of 40 percent of traveling public—high but declining since 1975/ages 24–49 with +$20,000 incomes most frequent guest/increasing number of single travelers and women travelers (25 percent in 1979)/steady demand for HI franchises with over 60 percent of new franchise locations sought by current franchises (+6)	Adequate labor supply although HI's labor-sensitive operating margins hurt by minimum wage increases (+2)	Strong capital structure, under-valued real estate and leadership position make credit readily available (+5)	Gasoline cost for customers is rising, which begins to curtail travel (−2)
Products group	Major competition outside the HI-customer system/competitors don't operate in captive mode which can allow more freedom/some competitors more price competitive on standardized items (−2)	Large captive market via HI system/limited competitive experience outside this captive market/franchises' resistance to being required to buy through product group businesses certain standardized items (+3)	Decreasing labor intensity via mechanization (+2)	Because of low-profit margins and captive design must seek capital resources primarily within corporate structure (−1)	Available through cost-escalating raw materials (0)
Trailways	Powerful competition from Greyhound on price, facilities, size, etc./increasing competition from other transportation sectors like airlines, trains, and package delivery services/intensive price-cost squeeze (−6)	Customer profile quite different from typical HI guest, especially in income/limited gains in passenger miles since 1975/no strong customer loyalty (−2)	Labor cost rising though some laborsaving technology improvements (−1)	Weak capital structure in highly competitive industry lessens available credit (−2)	Energy costs, especially fuel, rising significantly (−3)

Delta Steamship	Stiff competition from foreign cargo vessels in all routes/LASH technology improving relative position/major U.S.-flag carrier (+2)	Primarily agriculture and manufacturing importers and exporters at both ends of route structure/strong in Gulf ports area (+2)	Severely dependent on independent longshore workers/decreasing labor intensity via LASH technology (−2)	Legislation access to U.S. government low-interest loans and cost subsides (+5)	Energy costs, especially fuel, rising significantly (−3)
Freestanding restaurants	Stiff competition from several nationwide chains, but Perkins' position in northern U.S. rather strong/expanding primary demand which negates, to some extent, competitive impact/opportunities for additional acquisition (+1)	Customers profile quite similar to typical HI guest/family-oriented image/good brand identity in current geographic locations/trend of increased outside dining and more single households quite favorable/substantial franchise network and interest (+5)	Nonskilled labor positions/labor intensive/adequate supply though profit margins sensitive to minimum wage (+1)	Adequate capital structure and operating history for outside credit/HI corporate resources (+2)	Rising energy costs in operating units and in food products (−2)
Casino gaming	Growing competition in each of the four legalized gambling markets in U.S./but no dominant competitor overall/ rapidly growing primary demand related to increased leisure time and aging population (+5)	Customer profile very similar to typical HI guest/HI name, image, and reputation should prove quite beneficial/changing population demographics —baby boom age, single households, increasing leisure time—are strongly favorable (+8)	Temporary labor shortages but benefit by HI link in hotel, food, and lodging side/rising labor costs (−2)	Impressive profit potential but too early to tell/HI corporate resources (+1)	Fuel-sensitive business and energy-intensive facilities (−3)

most opportunistic task environments are found with the hotel and casino groups. The similarity of their competitive advantages (existing or potential) and favorable opportunities suggest strong synergy between the two groups from a corporate perspective. The task environment of freestanding restaurants appears favorable, with several dimensions suggesting limited but clearly exploitable opportunities. Delta Steamship encounters selectively favorable opportunities, while Trailways' task environment presents several formidable threats.

From a corporate-level perspective, the remote and task environment analyses identify factors that suggest that the greatest opportunities exist in hospitality-related businesses and the most pressing threats face its Trailway bus operation.

chapter 5

Environmental forecasting

Importance of forecasting

Although change in the 1970s was rapid, most observers agree that greater changes and greater challenges for strategic managers will come in the decade of the 1980s. The crucial responsibility for managers will be to ensure their firm's capacity for survival by anticipating and adapting to environmental changes in ways that provide new opportunities for growth and profitability. The impact of changes in the remote and task environments must be understood and predicted.

Even the largest and most firmly entrenched firms and industries must be prepared for change. The $4.2 billion loss in the U.S. auto industry during 1980 indicates what can happen when firms fail to place a priority on environmental forecasting. Despite a 20 percent penetration of the U.S. new car market by foreign competition in 1971, the oil embargo in 1973, rapidly climbing fuel prices, and the uncertain supply of future crude oil, the long-term implications of these predictable factors on future auto sales were largely ignored by U.S. automakers. Because it was not open to changes in technology, Detroit was left without viable, fuel-efficient, quality-made alternatives for the American market. On the other hand, the Japanese anticipated the future need for fuel efficiency, quality, and service through careful market research and environmental forecasting. As a result, the Japanese gained additional market share at Detroit's expense.

American auto makers now plan to spend $80 billion on product and capital investment strategies to recapture their lost market share; they now realize that success in strategic decisions rests not solely on dollar amounts but also on effective anticipation and preparation for the future. Insightful forecasting of the changing forces in the turbulent environment is, therefore, an essential part of strategic management. One more example is the case of U.S. Steel as described in Strategy in Action 5–1.

It is evident that strategic managers need to develop skill in predicting significant environmental changes. To aid the search for opportunities and constraints in the future, the following steps are necessary.

strategy in action, 5-1

U.S. Steel

The recession of the late 1970s hurt the U.S. steel industry, especially U.S. Steel Corp. Their shipments dropped 10 percent in the third quarter of 1979, and fell even further in the fourth quarter. David Roderick, the chief executive officer of the country's number 1 steel company said, "It would be a disaster if we continue this insidious liquidation of the steel industry."

To save the company, U.S. Steel developed a plan which called for a massive efficiency drive in steel by shutting down unprofitable facilities, even though that would substantially reduce capacity. Capital spent on steel operations would be directed only to improve productivity of existing plants, not for expansion of capacity to meet growing domestic demand. With such a contraction, U.S. Steel was taking a tremendous risk by giving up market share for higher profits in the near term. Under this strategy, U.S. Steel would also steer away from steel, devoting a greater portion of capital to nonsteel lines where it had greater hopes for profit growth. These lines included chemicals, transportation, resource development, and various construction and engineering operations.

However, the U.S. Steel plan was not certain to save the company. Without an inventory profit of $124.5 million, the operating income of $33 million in 1978 would have been a $91.5 million loss. In fact, this loss calculation was before deducting steel's share of $191.4 million in corporate interest and financing expenses.

During periods of inflation all capital-intensive companies report illusory profit, because their depreciation charges reflect historical costs, not current replacement costs. If this understatement of real depreciation is great enough, a company may be liquidating in real terms, because it is not generating enough capital through depreciation charges to cover replacement costs. Figuring depreciation on a replacement cost basis, U.S. Steel lost $902 million in 1973–1978 in real terms, instead of earning the $2.9 billion as was reported.

The company's grand strategy for warding off this wholesale liquidation of its steel operation was to pare down the business, betting that the surviving core would be a thriving, profitable unit. The company, meanwhile, initiated a tough review of its product offerings, and those that did not meet strict financial guidelines for future profitability would be jettisoned. U.S. Steel also tightened on sales controls and got tougher with labor, including an expression of willingness to give up its no-strike agreement with the United Steelworkers to get rid of costly wage guarantees.

Yet, without changes in depreciation and tax policies, the problem could only worsen. In 1979, for example, the company failed to generate the $1.5 billion needed for maintenance alone.

Indeed, some customers were already expressing grave doubt about the survival of U.S. Steel. Some of them even lined up with foreign sources to assure steel supplies in the 1980s. To date the U.S. government's only significant gesture to help the faltering domestic industry was its loan-guarantee program for troubled steelmakers.

Dave Roderick said, "The solution is not government guarantees. It is to create an economic and investment climate that will encourage companies that are credit-worthy to go out and get the funds, and put in the investment to build up the industry."

Source: Based on the article "Big Steel's Liquidation," from the September 17, 1979 issue of *Business Week*.

1. Select the key variables in the environment critical to the firm.
2. Select the sources for major environmental information.
3. Evaluate approaches or techniques of forecasting.
4. Integrate results of the forecasts into the strategic management process.
5. Monitor the critical aspects of forecast management.

Select the key variables in the environment

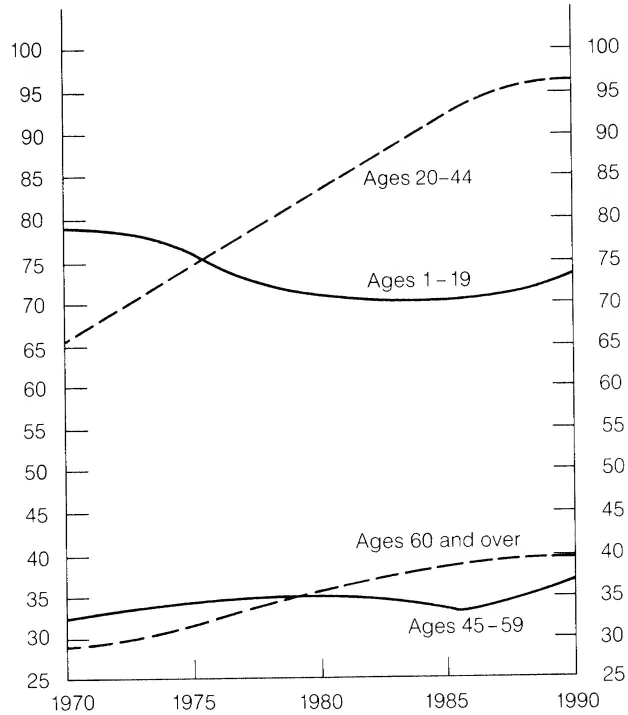
Several management experts have argued that the single most important cause of the turbulent business environment is the change in population structure and dynamics. This change, in turn, produces other major changes in the economic, social, and political environments.

Historically, population shifts tended to occur on a 40–50-year time scale and, therefore, had little relevance to business decisions. However, during the second half of the 20th century, population changes have become radical, erratic, contradictory, and therefore of great importance.

For example, the U.S. baby boom between 1945 and the mid-1960s has had and will have a dramatic impact on all parts of society—from maternity wards to schools and now to the labor force and the marketplace. This population bulge now is facing heavy competition for jobs, promotions, and housing, despite their highest-ever education level. Compounding this dilemma are the heightened demands of women and racial minorities. The lack of high-status jobs to fit the high expectations of the large educated labor force poses a potential for major social and economic changes—particularly as they encounter the increasingly large, aging labor force that find it difficult to give up their status, power, and employment when retirement programs are either not financially attractive or not available at the traditional age of 65. (See Figure 5–1 for comparative population growth projections.)

Obviously, the demands of these two groups will have important effects on social and political changes in terms of lifestyle, consumption patterns,

figure 5-1
Population growth by age group (millions)



Source: Bureau of the Census, U.S. Department of Commerce, 1980.

and political decisions. In economic terms, the size and potential affluence of both groups suggest increasing markets for housing, consumer products, and leisure goods and services.

Interestingly, the same shifts in population, life expectancies, and education have occurred in many of the developing nations. However, developing nations face the opposite population configurations. Although birthrates have also declined, survival rates, because of medical improvements, have created a large population of people reaching adulthood in the 1980s. Jobs and food are expected to be in short supply. Therefore, many developing countries will face severe social and political instabilities unless they can find appropriate work for their surplus labor.[1]

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[1] Peter Drucker (*Managing in Turbulent Times*, New York: Harper & Row, 1980) suggests that the practice of production sharing between developed and developing nations can be the economic integration needed by both groups of countries. Production sharing will include bringing together the abundant labor resources of the developing countries with the management, technology, educated people, markets, and purchasing power of the developed countries.

The rates of population increase can obviously be of great importance, as indicated by the contrasting effects forecasted above. If a growing population has sufficient purchasing power, new markets will be developed to satisfy their needs. However, too much growth in a country with a limited amount or a drastic inequity in distribution of resources may result in major social and political upheavels and may pose substantial risks for businesses.

If forecasting was as seemingly simple as predicting population trends, strategic managers would only need to examine census data to predict future markets. For example, all of the adults who will be producing and buying in 1995 are alive today. But economic interpretations are very complex. Migration rates, mobility trends, birth, marriage, and death rates, and racial, ethnic, and religious structures confound population statistics. In addition, resource development and its political use in this interdependent world further confuse the problem—as evidenced by the actions of some of the oil states like Saudi Arabia, Iraq, Libya, and Kuwait. Changes in political situations, technology, or culture add further complications.

Domestically, the turbulence is no less severe. The continually changing products and services, changing competitors, uncertain government priorities, rapid social change, and major technological innovations all add to the complexity of planning for the future. To grow, be profitable and, at times, even to survive in this turbulent world, a firm needs sensitivity, commitment, and skill in recognizing and predicting the variables that will most profoundly affect its future.

Who selects the key variables? Although planning executives or committees may assist in obtaining forecast data, the responsibility for environmental forecasting usually lies with top management, as is the case at the Sun (Oil) Company. The Sun Company assigns the responsibility for the long-range future of the corporation to the chairpersons and vice chairperson of the board of directors. One of the key duties of the vice chairperson is environmental assessment. In this context, *environment* refers not to the air, water, and land but rather to the very general environment of economics, technology, politics, and society in which Sun currently operates and will have to operate in the future.

The environmental assessment group consists of Sun's chief economist, a specialist in technological assessment, and a public issues consultant—all reporting to the vice president of environmental assessment. The chief economist evaluates and forecasts the state of the economy; the technological assessment specialist covers technology and science; and the public issues consultant concentrates on politics and society.[2]

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[2] Eric Weiss, "Future Public Opinion of Business," *Management Review*, March 1978, p. 9.

However, headquarter's capability and proficiency may be limited in analyzing political, economic, and social variables around the world. Therefore, on-the-spot personnel, outside consultants, or company task forces may be assigned to assist in forecasting.

What variables should be selected? A list of key variables that will have make-or-break consequences for the firm must be developed. Some may have been crucial in the past and others may appear important in the future. This list can be kept manageable in length by limiting key variables in the following ways:

1. Include all variables with high impact despite low probability of occurrence, e.g., trucking deregulation, and those with high probabilities regardless of impact, e.g., a minimal price increase by a major supplier. Delete others with low impact and low probabilities.
2. Disregard major disaster events such as nuclear war.
3. Aggregate when possible into gross variables, if smaller variables are linked to it, e.g., a bank loan is based on the dependability of a company's cash flow moreso than on its component sources.
4. If the value of one variable is based upon the value of the other, separate the dependent variable for future planning.[3]

Limits of money, time, and skill in forecasting prevent a firm from predicting many variables in the environment. The task of predicting even a dozen variables is substantial. Often firms try to select a set of key variables by analyzing the environmental factors in the industry that are most likely to force sharp growth or decline changes in the marketplace. For the furniture, appliance, and textiles industries, housing starts are significant. Housing, in turn, is greatly affected by high interest rates.

Figures 5-2 and 5-3 identify some of the key issues that may have critical impacts on a firm's future success. Examples of the importance of a few of these variables are also presented.

Select the sources for major environmental information

Before forecasting can begin in a formal way, appropriate sources of environmental information should be identified. The casual gathering of strategic information which is part of the normal course of executive reading, interactions, and meetings is subject to bias and must be balanced with alternative viewpoints. Although *The Wall Street Journal, Business Week, Fortune, Harvard Business Review, Forbes,* and other popular trade and scholarly journals are important sources of forecasting information, more formal, deliberate, and structured searches are desirable for strategic forecasting.

[3] Robert E. Linneman and John D. Kennell, "Shirt-Sleeve Approach to Long-Range Plans," *Harvard Business Review*, March-April 1977, p. 145.

figure 5–2
Key issues in the remote environment

1. *Economic considerations.*
Economic purchasing power depends on current income, savings, prices, and credit availability. The economic trends to be forecasted often attempt to answer the following questions.

What are the probable future directions of the economies in the corporation's regional, national, and international markets? What changes in economic growth, inflation, interest rates, capital availability, credit availability, and consumer purchasing power can be expected?

What income differences can be expected between the wealthy upper-middle class, working class, and underclass in various regions?

What shifts in relative demand for different categories of goods and services can be expected?

Example. The record-setting high interest rates of 1980 and 1981 resulted in a general economic washout in the United States. Industries that depend upon long- and short-term credit of their sales, such as housing and automobiles, were most severely affected. Despite the possibility that higher interest rates would be used to curtail the increasing inflation, little effort was made by loan institutions to develop innovative loan programs such as the variable interest loans.

2. *Social considerations.*
Within the context of the rapidly changing social environment of the highly interdependent spaceship earth, businesses feel great pressure to respond to the expectations of society more effectively.

What effect do changes in social values and attitudes regarding childbearing, marriage, lifestyle, work, ethics, sex roles, racial equality, education, retirement, pollution, energy, and so on have on the firm's development? What effect will population changes have on major social and political expectations—at home and abroad? What constraints or opportunities will be developed? What constraints or opportunities will be developed? What pressure groups will increase in power?

Example. The declining birthrate of the United States is a threat to some industries producing children's food, toys, clothes, and furniture. Strategy in Action 5–2 on the baby-food industry discusses how forecasting by trend extrapolation of birthrates in the late 1950s was so inaccurate that it created a severe threat to firms such as the Gerber Company. The six firms that survived or prospered into the 1980s were those who learned to recognize socio-cultural value changes and to incorporate such changes in their strategic forecasts.

3. *Political considerations.*
Although political forecasts are usually based on soft data, as compared to hard data in economics, the impact of political issues and trends is frequently as important as economic or technological variables.

What changes in government policy can be expected regarding industry cooperation, antitrust, foreign trade, taxation, depreciation, environmental protection, deregulation, defense, foreign trade barriers, and other governing parameters? What success will the new administration have in achieving its stated goals? What effect will that success have on the firm?

Example. After the 1980 presidential election, major adjustments in the

figure 5-2 ***(concluded)***

political environment forecasts were made to reflect the new priorities in military defense, private sector growth, and reduced government spending of the Reagan administration.

Will specific international climates be hostile or favorable? Is there a tendency toward instability, corruption, or violence? What is the level of political risk in each of the foreign markets? What other political or legal constraints or support can be expected in international business (e.g., trade barriers, equity requirements, nationalism, patent protection, etc.)?

Example. Despite the low political risk of investment in Canada, several major U.S. firms discovered the importance of in-depth environmental forecasting. Although the Quebec separatist movement was known, ITT Rayonier dismissed its potential effect on its construction of a $120 million pulp mill. ITT's use of English-speaking supervisors, their conflict with the separatists, a power struggle between two labor federations, and a shortage of skilled labor more than doubled the construction cost to $250 million. Asbestos Corp. of America was also surprised when the province of Quebec nationalized their asbestos mines. Both firms underestimated the significance of growing nationalism.

4. *Technological considerations.*
Technological innovations can give the firm a special competitive advantage. Without continued product or service improvement, profitability and survival are often jeopardized.

What is the current state of the art? How will it change? What pertinent new products or services are likely to become technically feasible in the foreseeable future? What is the future impact of technological breakthroughs in related product areas? How will they interface with other remote considerations such as economic, social values, public safety, regulations, court interpretations, and regulations?

Example. Recent applications of sophisticated computer technology to telephone interconnects such as PBX units have developed an entire new industry that is seen as a first step toward the integrated electronic office of the future. Decisions by the FCC curtailed previous monopolistic practices of AT&T that excluded the use of equipment from other than AT&T sources. The result has been the spin-off from AT&T of a marketing-oriented unit that will compete head-on with firms seeking to relate computers to communication systems. Among the announced competitors are Xerox, IBM, Exxon, Volkswagen, ROLM Corp., Northern Telecom, Mitel Corp., and Nippon Electric Co.

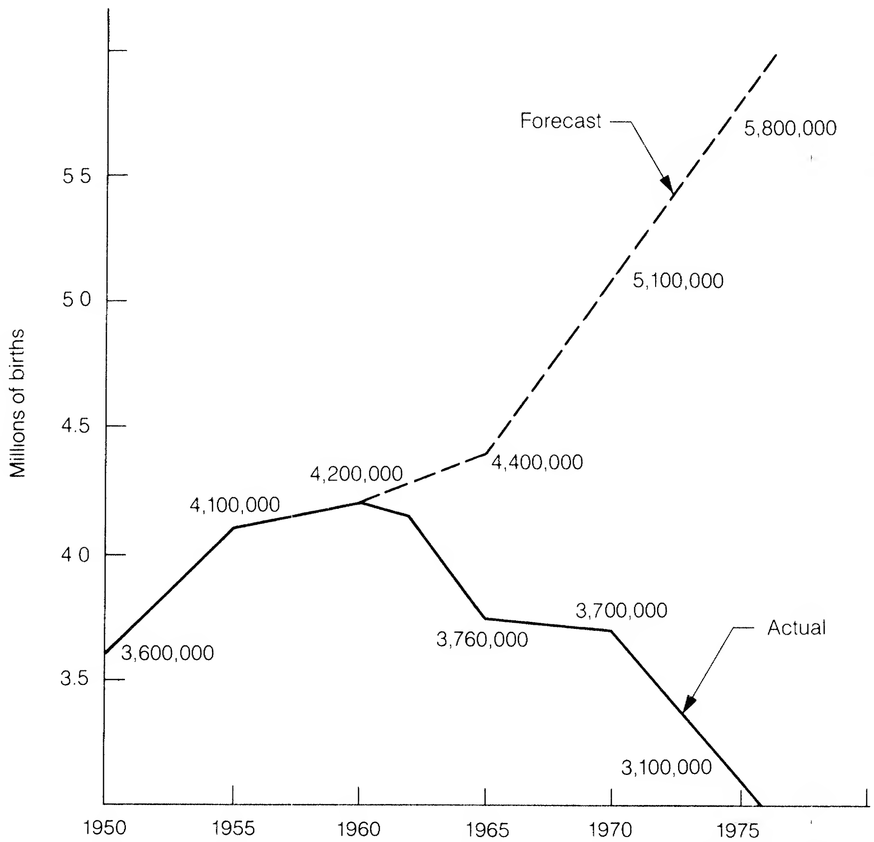
strategy in action, 5-2
The Baby-Food Industry

During the postwar years and the baby boom that followed, the attractive profits of baby-foods industry lured a number of firms, but the six firms that survived the competition by 1965 were Gerber Products, Beech-Nut Foods, H. J. Heinz, Swift & Company, Mead Johnson & Company, and Abbott Laboratories. They comprised approximately 91 percent of indus-

strategy in action, 5-2 ***(continued)***

try sales. Each firm had predicted that the high birthrate would continue indefinitely. Therefore, they prepared to compete in a market that had an increasingly high demand expectation. However, there proved to be a considerable gap between the baby-food producers' forecast of the birthrate and the actual number of births over the 1960 to 1976 period. None of the baby-food companies expected the birthrate to decline 42 percent during this period—as evidenced by the comparison of 1958 Gerber forecast to actual birthrate in the following graph.

Comparison of forecast birthrates with actual birthrate (1950–1975)



Source: Gerber Products' Long-Range Forecast, Annual Report, 1958; U.S. Bureau of the Census.

In anticipation of the forecast, baby-food manufacturers had built a number of new plants and warehouses only to find that a significant excess capacity developed as a result of continued birthrate decline in the United States.

As the firms saw the demand for their products shrinking, they contin-

strategy in action, 5-2 ***(concluded)***

ued to be optimistic in their expectations regarding the likelihood of revitalization of this industry—despite evidence to the contrary. Even in 1978, when the oldest of the postwar baby-boom mothers was 31 years of age, the baby-food firms believed the potential mothers would reverse the birthrate. Socialcultural value changes were not incorporated into their forecasts.

Because of the high expectations regarding future profitability of the industry, none of the entrenched firms would reduce their excess capacity. Emotional exit barriers were high because their special baby-food image made them reluctant to use their assets for other food processing businesses—especially for the single business companies of Beech-Nut Foods and Gerber. As a result of excess productive capacity over demand, a price war and promotional dealing reduced the profits of all firms until government price controls prompted them to recognize a need for a truce. Each firm had its strategic reasons for remaining in the baby-food industry during the decade of declining sales volumes and thin profit margins. If the number of births increased beyond the 4.3 million level, the industry could become profitable for all the firms. Unfortunately, continued rose-colored glasses or personal stubbornness tended to limit their openness and willingness to reexamine the assumptions behind their forecasts.

Source: Based on the article Gerber: "Selling more to the same mothers is our objective now" from the October 16, 1978 issue of *Business Week*.

figure 5-3
Key issues in the task environment

1. *Competitive position.*

   How probable are important new competitors into the industry? Will they offer substitute or competing products? What strategic moves are expected by existing rivals—inside and outside the United States? What competitive advantage is necessary in selected foreign markets? What will be the competitor's priorities and their ability to change? Is their behavior predictable?

   Example. Employing a penetration strategy similar to that used in auto, steel, shipbuilding, and television markets, Japanese medical electronic makers are gaining a niche with low-cost, stripped-down versions of competitors' equipment. American competitors, like General Electric, dismissed the Japanese strategy by insisting that users of medical electronic equipment are not concerned with price but equality. However, as in past entry strategies, the Japanese researched the needs of the market. They then began development of a three-dimensional scanner-monitor that was a major technical breakthrough and may eventually give them a competitive edge in the marketplace.

2. *Customer profiles and market changes.*

   What is and will be considered as needed value by our customers? Is market research done, or do managers talk to each other to discover what the customer wants? Which customer needs are not being met by existing products? Why? Are R&D activities underway to develop means for fulfilling these needs? What is their status? What channel should be used?

figure 5-3 ***(concluded)***

Example. The Japanese research their future customer needs and wants by interviewing product owners of their major competitor to determine desired improvements. This can be best illustrated by the manner in which the Japanese identified Volkswagen's shortcomings by interviewing owners in the United States in the mid 1970s. They then designed Toyotas and Datsuns accordingly and consequently overcame the Beetles' dominance in the United States.

What demographic and population based changes can be anticipated? What do they portend for the size of the market and sales potential? What new market segmentation or product development might develop as a result of these changes? What will be our customer groups' buying power?

Example. Because 95 percent of its $3.5 billion in revenues are generated from soft drinks and other beverages, Coca-Cola has become concerned about the aging of the prime soft-drink population—13–24 year olds. Because Coke can identify the key population variables that will have make-or-break consequences for their product lines, it can more accurately forecast its future market potential. As a result, Coke has decided to pursue the aging population bulge in the United States by diversifying into wines and by further expanding internationally with their soft-drink products in order to tap the growing youth markets in foreign countries.

3. *Suppliers and creditors.*

What is the likelihood of incurring major cost increases because of a dwindling supply of natural resource-based raw materials? Will sources of supply be reliable—especially energy? Are there any reasons to expect major changes in costs and availability of inputs as a result of money, people, or subassembly problems? Which suppliers and creditors can be expected to respond to special emergency requests?

Example. As short-term interest rates skyrocketed in late 1979 to 20 percent, hundreds of small firms fell into the marginal or money-losing categories. Often their bank lending officers became alarmed and called in the loans. The resulting squeeze forced many of these business into bankruptcy.

4. *Labor market.*

Are potential employees available in the needed geographic areas who possess the desired skills and abilities? Are colleges and vocational-technical schools located near plant or store sites to aid in the training needs? Are labor union relations in the industry conducive to expanding company needs for more employees?

Example. The decades of the 1950s and 1960s were periods of business expansion into the southern states where manpower was plentiful and labor unions were comparatively weak. In the 1970s, northern states regained a measure of attractiveness because they were able to offer unemployed or underemployed skilled workers and attractively priced industrial sites.

Figure 5–4 presents a list of published sources that can be used in forecasting. A review of these sources will help strategic managers to identify information sources which can help meet specific forecasting needs. If the firm can afford the time and expense, primary data should also be gathered by researching such areas as market factors, technological changes, and competitive and supplier strategies.

figure 5-4
Sources for remote environment forecasts

A. Economic considerations.
  1. Predicasts (most complete and up-to-date review of forecasts).
  2. National Bureau of Economic Research.
  3. Handbook of Basic Economic Statistics.
  4. Statistical Abstract of the United States (also includes industrial, social, and political statistics).
  5. Publications by the Department of Commerce.
     a. Office of Business Economics (e.g., *Survey of Business*).
     b. Bureau of Economic Analysis (e.g., *Business Conditions Digest*).
     c. Bureau of Census (e.g., *Survey of Manufacturers,* and various reports of population, housing, and industries).
     d. Business and Defense Service Administration (e.g., *United States Industrial Outlook*).
  6. Securities and Exchange Commission (various quarterly reports on plant and equipment, financial reports, working capital of corporations).
  7. *The Conference Board.*
  8. *Survey of Buying Power.*
  9. *Marketing Economic Guide.*
  10. Industrial Arts Index.
  11. U.S. and National chambers of commerce.
  12. American Manufacturers Association.
  13. *Federal Reserve Bulletin.*
  14. *Economic Indicators,* annual report.
  15. *Kiplinger Newsletter.*
  16. International economic
     a. Worldcasts.
     b. Master key index for business international publications.
     c. Department of Commerce.
        (1) Overseas business reports.
        (2) Industry and Trade Administration.
        (3) Bureau of Census—Guide to Foreign Trade Statistics.
  17. Business Periodicals Index.

B. Social considerations.
  1. Public opinion polls.
  2. Surveys such as *Social Indicators and Social Reporting,* The annals of the American Academy of Political and Social Sciences.
  3. Current controls: Social and behavioral sciences.
  4. Abstracts services and indexes for sociological, psychological, and political journal articles.
  5. Indexes for *The Wall Street Jounral, New York Times,* and other newspapers.
  6. Bureau of Census reports on population, housing, manfuacturers, selected services, construction, retail trade, wholesale trade, and enterprise statistics.
  7. Various reports from groups such as the Brookings Institute and the Ford Foundation.
  8. World Bank Atlas (population growth and GNP data).
  9. World Bank-World Development Report.

C. Political considerations.
  1. *Public Affairs Information Services Bulletin.*
  2. CIS Index (Congressional Information Index).

figure 5–4 ***(continued)***

3. Business periodicals.
4. Funk & Scott (regulations by product breakdown).
5. Weekly compilation of presidential documents.
6. *Monthly Catalog of Government Publications.*
7. *Federal Register* (daily announcements of pending regulations).
8. Code of Federal Regulation (final listing of regulations).
9. Business International Master Key Index (regulations, tariffs).
10. Various state publications.
11. Various information services (Bureau of National Affairs, Commerce Clearing House, Prentice-Hall).

D. Technological considerations.
1. *Applied Science and Technology Index.*
2. *Statistical Abstract of the United States.*
3. Scientific and Technical Information Service.
4. University reports, congressional reports.
5. Department of Defense and military purchasing publishers.
6. Trade journals and industrial reports.
7. Industry contacts, professional meetings.
8. Computer-assisted information searches.
9. National Science Foundation, annual report.
10. *Research and Development Directory,* patent records.

Sources for task environment forecasts

A. Competition and supplier considerations.
1. Target Group Index.
2. U.S. Industrial Outlook.
3. Robert Morris annual statement studies.
4. Troy, Leo Almanac of Business & Industrial Financial Ratios.
5. Census of Enterprise Statistics.
6. Securities and Exchange Commission (10-K reports).
7. Annual reports of specific companies.
8. *Fortune 500 Directory, The Wall Street Journal, Barrons, Forbes, Dun's Review.*
9. Investment services and directories: Moody's, Dun & Bradstreet, Standard & Poor's, Starch Marketing, Funk & Scott Index.
10. Trade association publications.
11. Industry surveys.
12. Market research surveys.
13. *County Business Patterns.*
14. *County and City Data Book.*
15. Industry contacts, professional meetings, salespeople.
16. *NFIB Quarterly Economic Report for Small Business.*

B. Customer profile.
1. *Statistical Abstract of the U.S.,* first source of statistics.
2. *Statistical Sources* by Paul Wasserman (a subject guide to data—both domestic and international).
3. *American Statistics Index* (Congressional Information Service Guide to statistical publications of U.S. government—monthly).
4. Office of the Department of Commerce.
   a. Bureau of Census reports on population, housing, and industries.
   b. *U.S. Census of Manufacturers* (statistics by industry, area, and products).

figure 5-4 ***(concluded)***

   c. *Survey of Current Business* (analysis of business trends, especially February and July issues).
5. Market research studies (*A Basic Bibliography on Market Review,* compiled by Robert Ferber et al., American Marketing Association).
6. *Current Sources of Marketing Information: A Bibliography of Primary Marketing Data* by Gunther & Goldstein, AMA.
7. *Guide to Consumer Markets,* Conference Board (provides statistical information with demographic, social, and economic data—annual).
8. *Survey of Buying Power.*
9. *Predicasts* (abstracts of publishing forecasts of all industries, detailed products, and end-use data).
10. *Predicasts Basebook* (historical data from 1960 to present, covering subjects ranging from population and GNP to specific products and services. Series are coded by Standard Industrial Classifications).
11. *Market Guide* (individual market surveys of over 1,500 U.S. and Canadian cities. Data includes population, location, trade area, banks, principal industries, colleges and universities, department and chain stores, newspapers, retail outlets, and sales).
12. *County and City Data Book* (includes bank deposits, birth and death rates, business firms, education, employment, income of families, manufacturers, population, savings, wholesale, and retail trade).
13. *Yearbook of International Trade Statistics* (UN).
14. *Yearbook of National Accounts Statistics* (UN).
15. *Statistical Yearbook* (UN—covers population, national income, agricultural and industrial production, energy, external trade and transport.
16. *Statistics of (Continents): Sources for Market Research* (includes separate books on *Africa, America, Europe*).

C. Key natural resources.
1. *Minerals Yearbook, Geological Survey* (Bureau of Mines, Department of Interior).
2. *Agricultural Abstract* (U.S. Department of Agriculture).
3. Statistics of electric utilities and gas pipeline companies, Federal Power Commission.
4. Publications of various institutions: American Petroleum Institute, U.S. Atomic Energy Commission, Coal Mining Institute of America, American Steel Institute, and Brookings Institute.

Sources: Adapted from C. R. Goeldner and Laura M. Kirks, "Business Facts: Where to Find Them," *MSU Business Topics,* Summer 1976, pp. 23–76, reprinted by permission of the publisher, Division of Research, Graduate School of Business Administration, MSU; Francois E. deCarbonnel and Roy G. Donance, "Information Source for Planning Decisions," *California Management Review,* Summer 1973, pp. 42–53; and A. B. Nutt, R. C. Lenz, Jr., H. W. Landford, and M. J. Cleary, "Data Sources for Trend Extrapolation in Technological Forecasting," *Long-Range Planning,* February 1972, pp. 72–76.

Evaluate approaches and techniques of forecasting

In today's turbulent world, strategic managers depend upon a wide range of forecasting approaches. This section will evaluate several of the more typical techniques.

Economic forecasts. Once only forecasts of economic variables were made to facilitate strategic management. The economic forecasts were concerned

with remote economic factors such as general economic conditions, disposable personal income, consumer price index, wage rates, and productivity. Originated by governmental and private sources, these economic forecasts serve as the framework for industrial and company forecasts. Industry and company forecasts deal with task environment concerns such as sales forecasts, market share, and other economic trends pertinent to the firm.

With the advent of sohpisticated computers, the government and other firms who could afford them contracted with private consulting firms to develop econometric models of their economic environment. *Econometric models* utilize complex simultaneous regression equations to relate occurrences in the economy to areas of corporate activity. They are especially useful when good information is available on causal relationships and when large changes are anticipated. During the relatively stable decade of the 1960s and on into the 1970s, econometrics became on of the nation's fastest growth industries. However, since early in 1979, the big three econometric firms—Data Resources (McGraw-Hill, Inc.), Chase Econometrics (Chase Manhattan Bank), and Wharton Econometric Forecasting Associates (Ziff-Davis Publishing Co.)—have fallen on hard times. The explosion of oil prices and inflation and the growing interdependence of the world economy have created problems beyond the inherent limits of the econometric models. Despite their enormous technological resources, they still depend upon the judgment of the model builders. In turbulent times, that judgment has not been dependable.[4]

Four more widely used and less expensive approaches to forecasting are time series analysis, trend analysis, judgmental, and causal models.

Trend analysis assumes that the future will be a continuation of the past and can be projected as a long-range trend. If sufficient historical data such as annual sales are readily available, a trend analysis can be determined quickly and inexpensively.

In a trend analysis such as in Figure 5-5, concern should focus on long-term trends such as trend C, which represents 10 years of fluctuating sales. Trend A, where three excellent years were used in the trend analysis, would be too optimistic. However, the four bad years depicted in trend B would represent a far too pessimistic outlook.

The major limitation of trend analysis is the assumption that all relevant variables will remain relatively constant in the future. Sudden changes in the variables upset the trend prediction.

Time series analysis is a more complex quantitative approach than trend analysis. It attempts to identify a pattern between a combination of trend, seasonal, and cyclical factors based on historical data. It also assumes that the past is prologue to the future. Time series techniques, including exponential smoothing, are relatively simple, well-known, inexpensive, and rela-

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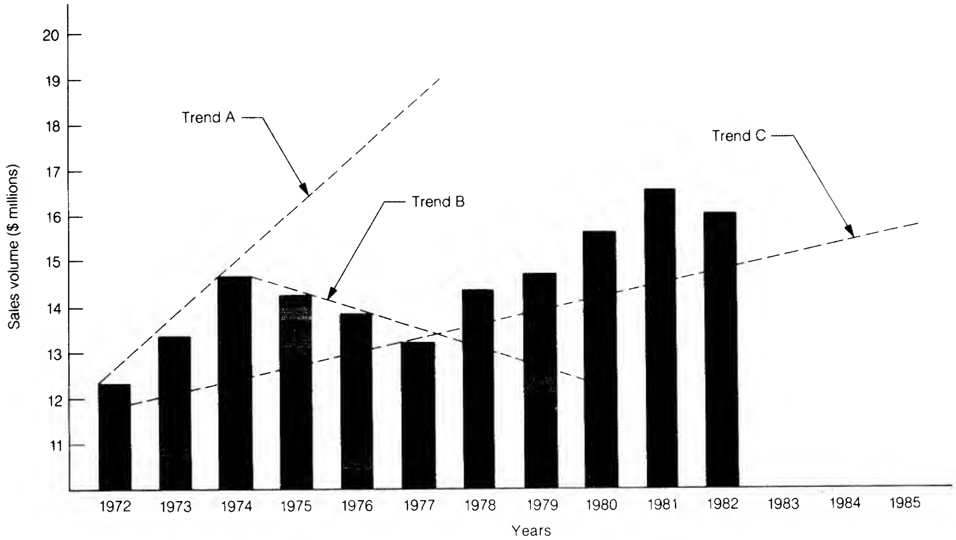
[4] "Where the Big Econometric Models Go Wrong," *Business Week*, March 30, 1981, pp. 70-73.

figure 5-5
Interpretations in trend analysis



tively accurate. However, these models are subject to gross miscalculations by assuming fixed and unchangeable relationships between factors and pressures incorporated in the subjective interpretation. For example, auto company economists have been forbidden to give pessimistic forecasts until recent years.

Judgmental approaches are useful when historical data is not available or it is hard to use. Examples of judgmental approaches are sales-force estimates, juries of executive opinion, and customer surveys.

Sales-force estimates are aggregate opinions of salespeople gleaned from customer contacts regarding their intentions and opinions for specific products. They can be relevant if customers respond honestly and remain consistent in their intentions.

Juries of executive opinions combine joint estimates of executives from marketing, production, finance, and purchasing and then average their views. No elaborate math or statistics are required.

Customer surveys may be conducted by interviews or telephone questionnaires, but require well stated and understood questions asked of a random sample of the relevant population. Surveys can provide in-depth and valuable information. However, they are often difficult to construct and time consuming to administer. Many market research firms use this approach. One strong advocate of judgmental approaches is the senior partner of Lord, Abbett Investment, as is discussed in Strategy in Action 5-3.

Causal approaches are useful if specific relationships are known between variables. If a change in one economic variable signals a future change in a

strategy in action, 5-3

Lord, Abbett Investment

Development of investment strategies usually involves sophisticated econometric and mathematical models to forecast future investment values. However, John M. McCarthy, senior partner of Lord, Abbett Investment, a $3.6 billion investment company, has developed his own qualitative forecasting approach. As president of its $1.7 billion Affiliated Fund, McCarthy uses a subjective approach that examines events for tangible signs of pending changes in the economy. He believes that if you wait for the obvious to be discussed on TV, the process is already under way for solving the economic problem and it is too late to invest for important gains.

While numbers and graphs are sometimes combined in the jury of executive opinion approach, McCarthy feels that by the time the numbers of the key indicators reflect changes in the economy, it is too late to aid investment strategies. Instead, his forecasts tend to focus on fundamental changes such as those dealing with interest rates, government investment incentives, and consumer trends. Among McCarthy's specific forecasts are a drop in interest rates in 1981, a probable return to the bond market, and a depressed consumer goods market until the mid 80s. He believes that President Reagan's savings and investment incentives will break the American habit of borrow and spend. Company and personal investment strategies will need to be fine tuned, as these and other forecasts do or do not become reality.

Generally, McCarthy looks for the generally unpopular investments. Often these are undervalued. An illustration of his unique but common-sense approach resulted in investment strategies of purchasing stocks that declined in price while interest rates climbed in 1980. Interest-sensitive issues, such as AT&T, utilities, and banks, account for about 18 percent of Affiliated's current portfolio.

Although this conservative strategy caused Lord, Abbett's growth rate to be below the averages of the Dow and Standard & Poor's 500 during the brief bull market in 1980, McCarthy has focused on long-term results. This forecasting approach and investment strategy enabled Affiliated to grow 173.1 percent compared to 105.5 percent for the Dow during the period January 1975 through September 1980.

Lord, Abbett follows the same forecast method and investment strategy in managing its $1.5 billion of pension fund money.

Source: "Lord, Abbett Senior Partner Weaves Theology into His Investment Credo," *The Wall Street Journal*, December 9, 1980.

major business variable such as sales demand of a given type of product, a causal model can be developed. For example, knowledge of personal income and growth of certain population segments are usually good predictors of certain basic consumer products.

Social forecasts. Reliance solely on economic indicators for strategic forecasting neglects many important social trends that can have a profound impact upon the nation and its organizations. Some firms have recognized this importance and forecast social issues as part of their environmental scanning. Their purpose is to identify social trends and underlying attitudes.

The importance of social trends can be illustrated by the following example that incorporates the earlier stated significance of populations as a cause for turbulence in the environment.

> Three alternative assumptions on the fertility rate of young women have been projected: assumption I: 2.7 children/women; assumption II: 2.1 children/women; assumption III: 1.7 children/women. Under assumption I, the U.S. population in 2040 would total 450 million. However, with the lower fertility rate of assumption III, the population in 2040 would be only 240 million. The difference between the two projections in the year 2040 would be 210 million people. The consequences of these huge differences—socially, politically, and economically—will profoundly affect the strategic posture of firms selecting alternative assumptions.

Despite this simple example, social forecasting is very complex. Recent efforts have analyzed such major social areas as: population, housing, social security and welfare, health and nutrition, education and training, income, and wealth and expenditures.

A variety of approaches have been used in social forecasting. Three of the more frequently used techniques—trend analysis, time series analysis, and judgmental approaches—have been generally explained. The fourth approach called scenario development is probably the most popular of all techniques for social forecasting.

Scenarios are stories about the future that integrate objective and subjective parts of other forecasts. They are designed to help managers anticipate changes for the firm. Because scenarios are presented in an easy-to-understand form, they have gained popularity in social forecast situations. The process of scenario writing follows six steps.

1. Prepare the background by assessing the overall social environment under investigation (such as social legislation).
2. Select critical indicators and search for future events that may impact the key trends (growing distrust of business).
3. Analyze reasons for past behavior for each trend (perceived disregard for the environment).
4. Forecast each indicator in at least three scenarios showing:
   a. The least favorable environment.

   b. The likely environment.
   c. The most favorable environment.
5. Write the scenario from the viewpoint of someone standing in the future and describe conditions at the time and how they developed.
6. Condense the scenario length for each trend to a few paragraphs.

Figure 5–6 presents an example of a most likely scenario for the future state of business-government relationships on social issues. The purpose of such scenarios is to permit strategic managers to become prepared for alternative possibilities if certain trends continue, thus enabling contingency planning.

figure 5–6
Scenario on the future state of busines-government relations: Social issues

The government/corporate relationship in the 1978–1987 period continued to develop along patterns established in previous decades, with no major discontinuities or radical surprises. The most far-reaching and substantial change occurred late in the period when Congress enlarged the planning authority of its budget office, setting 5- and 10-year national manpower, natural resource, and other economic goals. This legislation primarily affected federal fiscal policies and contained no authority to compel action on the part of the private sector to meet the indicated goals.

Nevertheless, following the lead of West Germany, the federal government did offer some incentives to companies that acted to meet certain national objectives—for example, locating new industrial facilities in certain areas for social reasons (such as environmental or employment reasons). During the decade the government made a commitment to guaranteed jobs rather than guaranteed income.

In the environmental arena, economic incentives and penalties became the government's major tools for compliance. Effluent charges were established to interalize the costs of pollution. Other tax incentives and loans were made available to companies for the installation of pollution-control equipment. Congress also legislated a time limit for legal actions to block a construction project on environmental grounds.

In other regulatory areas, the government moved selectively, increasing requirements on some industries while reducing controls on others. For example, while moving to deregulate much of the air transport business, Congress at the same time passed a full-disclosure labeling act for prepared foods that requires the listing of all ingredients and the percentage of each ingredient. Congress also set a rule requiring that every proposal for new regulation be accompanied by a regulatory impact statement detailing the probable effects of the proposal on the economy.

Turning down proposals for federal chartering of corporations, Congress nevertheless acted to influence the internal governance of large corporations: it passed a full-disclosure law concerning most corporate activities and established a limit on the number of inside directors permitted to serve on the boards of directors. Legislation established due process and protection for whistle blowers (employees who report legal violations). The government placed stringent safeguards on corporate data banks containing information about employees and customers.

In the domain of social legislation affecting business, the minimum wage was indexed to the cost of living and Congress passed a comprehensive national health plan in which employers pay a significant portion.

Source: James O'Toole, "What's Ahead for Business-Government Relationships," *Harvard Business Review*, March–April 1979, p. 100.

Political forecasts. Some strategic planners desire to have political forecasts treated with the same seriousness and consideration given to economic forecasts. They believe that shifts toward or against a broad range of political factors can have profound effects on business success. Examples of such political factors are the size of government budgets, tariffs, tax rates, defense spending, the growth of regulatory bodies, and the extent of business leader participation in government planning.

Political forecasts of foreign countries are also important. Political risks increase the threat to businesses that are in any way dependent upon international subsidiaries or suppliers for customers or critical resources. The increasing world interdependence makes it imperative for firms of all sizes to consider political implications on their strategies.

Because of the billions of U.S. dollars lost in the 1970s from revolutions, nationalizations, and other forms of political instability, a number of multinational firms and consultants have developed a variety of global forecast approaches. Among the better known are:

Haner's Business Environmental Risk Index which monitors 15 economic and political variables in 42 countries.

Frost & Sullivan's World Political Risks Forecasts which predicts the likelihood of various catastrophes befalling an individual company.

Probe International's custom reports for specific companies which examine broad social trends.

Arthur D. Little's (ADL) developmental forecasts which examine a country's progress from the Stone Age to the computer age.[5]

Of all the approaches, ADL's forecasting techniques may be the most ambitious and sophisticated. With computer assistance, they follow the progress of each country by looking at five criteria: social development, technological advancement, abundance of natural resources, level of domestic tranquility, and type of political system. When a country's development in any one of these areas gets too far ahead of the other, tension builds and violence often follows. Using this system, political turbulence was forecast in Iran as early as 1972. ALD also foresees that uneven development will likely produce similar turmoil in 20 other countries such as Peru, Chile, Malaysia, and the Phillipines. ADL believes that the world is highly predictable if one asks the right questions. Unfortunately, too many executives fail to use the same logic in analyzing political affairs that they use in other strategic areas. Political analysis should be incorporated into the economic analyses routinely. Ford, General Motors, Pepsi, Singer, DuPont, United Technologies are among the many companies that follow ADL's advice.

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[5] Niles Howard, "Doing Business in Unstable Countries," *Dun's Review*, March 1980, pp. 49–55.

Technological forecasts. Such rapid and revolutionary technological changes as lasers, nuclear energy, satellites and other communication devices, desalination of water, electric cars, and miracle drugs have prompted many firms to invest in technological forecasts. Knowledge of the probable development of the technological improvements helps strategic managers prepare their firms to benefit from change. To make technological forecasts, all of the previously described techniques, except econometrics, can be used. However, the uncertainty of information about a technological change favors scenarios and two additional forecasting approaches: brainstorming and the Delphi technique.

Brainstorming is a technique used to help a group generate new ideas and forecasts. The analyses or criticisms of individual contributions are postponed so that creative thinking is not stifled or restricted. Because of the absence of interruptions, group members are encouraged to offer original ideas and to build on the innovative thoughts of other group members. At a later time the most promising of the ideas are thoroughly evaluated.

The *Delphi* technique uses a systematic procedure to obtain a consensus of opinions from a group of experts. The procedure includes:

1. A detailed survey of the expert opinion, usually through a mail survey.
2. A reading of the anonymously exchanged answers by the experts.
3. One or more revisions of answers to the same problems until convergence occurs.

This technique, although expensive and time consuming, can also be successfully used for social and political forecasting.

Choosing an approach. Debate exists over the accuracy of quantitative versus qualitative approaches with most research supporting quantitative models. However, the differences in predictions between the two types of approaches are often minimal. Additionally, it is many times the case that subjective or judgmental approaches may be the only practical methods to forecast trends in the political, legal, social, and technological areas of concern, that is, in the remote external environment.

Ultimately, the technique chosen depends on such factors as the nature of the forecast decision, the amount and accuracy of the information available, the accuracy level required, the time available to make the forecast, the importance of the forecast to the firm, the cost of the forecast, and the competence and interpersonal relationships of the managers and forecasters involved.[6] Frequently, assessment of these factors leads to the selection of a combination of quantitative and qualitative techniques, thereby strengthening the accuracy of the ultimate forecast.

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[6] Steven C. Wheelwright and Darral G. Clarke, "Corporate Forecasting: Promise and Reality," *Harvard Business Review,* November–December 1976, p. 42.

Integrate results of the forecasts into the strategic management process

Once the techniques are selected and the forecasts made, the results must be tied into the strategic management process. For example, the economic forecast must be related to the analyses of the industry, the suppliers, the competition, and key resources. Figure 5-7 presents a format for displaying interrelationships between forecasted remote environmental variables on the left margin and the influential task environmental variables across the top. The resulting predictions become a part of the assumed environment in formulating strategy.

It is critical that strategic decision makers understand the assumptions that served as the basis of the environmental forecasts. An example of this need is illustrated by the experience of Itel, a computer leasing firm. In 1978, Itel was able to lease 200 of its plug-in computers made by Advanced Systems and by Hitachi in large part because IBM was unable to make delivery of its newest systems. For 1979, Itel made a bullish sales forecast that it

figure 5-7
Task and remote environments impact matrix

Remote environments	*Task environments*			
	Key customer trends	*Key competitor trends*	*Key supplier trends*	*Key labor market trends*
Economic	*Examples:* Trends in inflation and unemployment rates		*Example:* Annual domestic oil demand and worldwide sulfur demand through 1987	
Social	*Example:* Increasing numbers of single-parent homes			*Example:* Increasing education level of U.S. population
Political	*Example:* Increasing numbers of punitive damage awards in product liability cases		*Example:* Possibility of Arab oil boycotts	
Technological		*Example:* Increasing use of superchips and computer-based instrumentation for synthesizing genes	*Example:* Use of cobalt 60 gamma ray to extend shelf-life of perishables	

would place 430 of its systems—despite the rumor that IBM would launch a new line of aggressively priced systems in the first quarter of 1979. Even Itel's competitors felt that customers would hold off their purchasing decisions until IBM made the announcement. However, Itel signed long-term purchase contracts with its suppliers and increased its marketing staff by 80 percent. This forecasting mistake and the failure to examine sales forecasts in relationship to competitors and suppliers was nearly disastrous. Itel slipped close to bankruptcy within less than a year.

Forecasting external events enables a firm to identify the probable requirements for success in the future, to formulate or reformulate its basic mission, and to design strategies to achieve goals and objectives. If the forecast identifies any performance gaps or inconsistencies between the firm's desired position and its present position, strategic managers can respond with strategic plans and actions.

Dealing with the uncertainty of the future is a major function of the strategic manager. The forecasting task requires systematic information gathering coupled with the ability to utilize a variety of forecasting approaches. It also demands a high level of intuitive insight to integrate risks and opportunities in formulating strategy. Intentional or unintentional delays, or lack of understanding of certain issues may prevent an organization from using insights advantageously gained from assessing the impact of broader environmental trends. Consistent sensitivity and constant openness for new and better approaches and opportunities are therefore essential.

Monitor the critical aspects of forecasting management

Although almost all aspects of forecasting can be considered as critical in specific situations, four aspects stand out as especially critical in the lifetime of a business.

The first of the critical aspects for a successful strategic forecast is the identification of factors that deserve forecasting. Although there are literally hundreds of different factors that might affect the firm, often a few factors of immediate concern such as sales forecast and competitive trends are most important.

Unfortunately, there are seldom enough time and resources available to completely understand all environmental factors that might be critical to the success of a strategy. Therefore, executives must depend on their collective experience and perception of what is important in the identification of factors worthy of the expense of forecasting.

The second critical aspect is to determine if there are forecast sources outside the firm that are both reputable and cost efficient which can expand the company's forecasting data base. Strategic managers need to locate federal and state governments, trade and industry associations, and other groups or individuals which can provide external data forecasts at reasonable costs.

The third critical aspect of forecast management arises with the decision to handle forecasting tasks in-house. Given the great credence which is often placed in formally developed forecasts—despite the inherent uncertainty of their data base—the selection of forecasting techniques which managers will personally employ is indeed critical.

A firm beginning its forecasting efforts is well advised to begin with less technical methods, such as the sales force estimates and the jury of executive opinion, rather than the highly sophisticated forecasting techniques such as econometrics. With added experience and understanding, the firm can add approaches that require greater analytical sophistication. In this way, managers learn to cope with the inherent weaknesses as well as the variable strengths of forecasting techniques.

The fourth critical aspect is the maintenance of understanding between developers/forecasters and users/managers. Too often the effectiveness of forecasts is limited by behavioral and organizational roadblocks such as:

1. The lack of mutual understanding of task and priorities.
2. The failure to recognize different role support for different situations.
3. The lack of understanding of different stages of applying methodologies.

Summary

Environmental forecasting starts with an identification of factors external to the firm that might provide critical opportunities or threats in the future. Both quantitative and qualitative strategic forecasting techniques are used to project the long-range direction and impact of these critical remote and task environment factors. The various techniques have strengths and weaknesses that must be understood in evaluating and selecting the most appropriate forecasting approaches for the firm. Usually more than one technique is advised to balance potential bias or errors of individual techniques.

Critical aspects in the management of forecasting include the selection of key factors to forecast, the selection of forecast sources outside the firm, the selection of forecasting activities to be done in-house, and the maintenance of understanding between developers and users of the environmental forecasts.

Questions for discussion

1. Identify five anticipated changes in the remote environment which you believe will affect major industries in the United States over the next decade. What forecasting techniques could be used to assess the probable impact of these changes?
2. Construct a matrix with forecasting techniques on the horizontal axis and at least five qualities of forecasting techniques across the vertical axis. Next, fill in the matrix to indicate the relative strengths and weaknesses of each technique.

3. Develop three heuristics, known as rules of thumb, to guide strategic managers in the use of forecasting.
4. Develop a two-page, typewritten forecast on a variable which you believe will alter the ability of your business school to prosper during the next 10 years.
5. Research prominent business journals and find two examples of firms which either profited or suffered from environmental forecasts.
6. Describe the background, skills, and abilities of the individual who you would hire as the environmental forecaster for your $500 million in sales per year firm. How would the qualifications differ for a smaller or larger business?

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chapter 5 cohesion case

Environmental forecasting at Holiday Inns, Inc.

Holiday Inns, Inc., uses several of the forecasting techniques discussed in Chapter 5 to project changes in its remote and task environments of major importance to future strategic position. The greatest emphasis, even at the

corporate level, is on environmental forecasting in hospitality-related factors. The primary environmental variables on which the company places forecasting emphasis are:

1. Customer
2. Social
3. Technological
4. Competition

Exhibit 1 summarizes some of the forecasting techniques in terms of what they focus on relative to these key environmental factors.

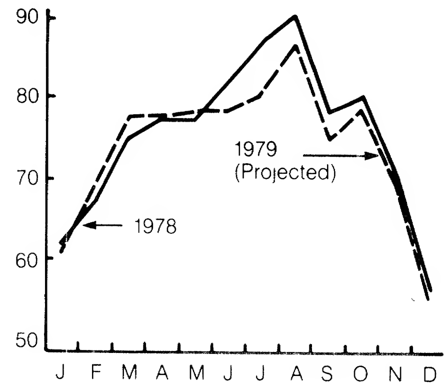
To help you understand these forecasts and how they might be useful, we will illustrate a few of the items in Exhibit 1.

exhibit 1
Environmental forecasting at Holiday Inns, Inc.

Main environmental factors	*Forecasting techniques*		
	Trend analysis	*Surveys*	*Judgment/scenarios*
Customers	Changing demographic profile Specific HI guest characteristics Historical occupancy rate cycles	Changing consumer preferences Perceptions and brand recognition of HI	Futuristic travel patterns and destination areas
Social	Baby-boom generation Household composition Women's changing role Use of leisure time	(little use)	Worldwide status of the travel industry
Technology	Energy-saving technology, especially in automobiles and hotel operation Gas prices and impact on vacation travel	(little use)	Future travel modes Computer usage in property management Communication, especially satellite, developments
Competition	Size and growth of competitors Location emphasis of key price/value available from competition	Level of consumer name recognition Consumer image and brand preference	Which competitors represent key threats to aspects of HI operations

In better managing properties on a weekly basis to ensure operating margins are maintained, projected occupancy cycles based on historical trends can be quite helpful from the corporate level (planning cash flows) to the individual hotel (budgeting and scheduling). Exhibit 2 shows system-wide occupancy projections for 1979 relative to actual 1978 levels. The widely

exhibit 2
Company-owned properties monthly domestic occupancy comparison 1979 versus 1978 ***(percent)***



fluctuating, yet historically consistent pattern can clearly accommodate weekly scheduling and budgeting of resources.

Trend analysis, surveys, and judgmental scenarios about changing customer profiles and social characteristics are where the major forecasting emphasis is placed at Holiday Inns. Using these various techniques, the following forecasts have been made about customer and social characteristics.

Fewer and later marriages mean that HI's customer base has broadened to include a greater concentration of single persons, couples, and business people with greater freedom to travel (**96, 106, 50**).[1]

The demographic characteristics of the typical hotel, restaurant, and casino guest are virtually identical: age 24–49, income over $20,000, with a preference for reliable and quality service instead of the lowest price (**53, 96**).

In three out of four instances, HI guests were male, but the trend to more women travelers is steadily growing (**96**).

The movement of the baby-boom generation through the prime traveling age (25–45) over the next 20 years foretells unprecedented growth opportunity in the hospitality business (**106**).

Futurists predict that by the end of the century, as larger numbers of people pursue business and travel, the travel industry will have become the world's largest (**104**).

[1] Numbers which are typed in parentheses at the end of sentences refer to paragraph numbers in the business case study.

Using similar techniques regarding competition and technology, Holiday Inns, Inc. has developed such forecasts as:

Holiday Inn hotels will remain the brand preference of over one third of the traveling public through the 1980s (**96**).

Hospitality facilities located in multiuser locations will dominate industry growth and development in the 1980s (**15**).

Even at $2 a gallon, highway driving habits will not change appreciably (**103**).

About 80 percent of U.S. adults approve of gambling and 60 percent participate in some form. Gaming is fast becoming a national pastime and is viewed by the public as a leisure activity (**63**).

Most countries served by Delta (Steamship) are undergoing continued development and industrial expansion. This thrust provides a market for imports of high-value goods—of which U.S. industry is a major supplier (**41, 44, 99**).

Are these forecasts accurate? Most seem plausible, although some have been previously questioned. At Best Western International, for example, forecasts predict a "17 percent cutback in auto travel as gas prices hit $2 a gallon." This view is shared by the American Petroleum Institute.

Holiday Inn executives disagree. They offer the following statement summarizing their various forecasts relative to the hospitality core of HI's business for the 1980s:

> The decade of the 1980s offers excellent potential for the hospitality industry. Business analysts see continued growth for travel through the end of the century.
>
> While temporary gasoline shortages have been a short-term negative factor in our operations twice in the past six years, we remain quite optimistic about gasoline availability for our customers. We expect occasional brief shortages, but by and large, we believe that adequate supplies will be available.
>
> Our optimism is fostered by a significantly more efficient car fleet and rising energy prices. The 1980 auto fleet is 55 percent more fuel efficient than its 1974 counterpart. In 1985, the average car will travel 27.5 miles per gallon of gas, a 37.5 percent increase over 1980. As gasoline prices rise, we believe the consumer will be more selective. Conservation is already becoming the rule and needless intracity travel is being curtailed. Our research tells us that our customers will continue to use their automobiles for intercity travel and vacations. Thus, we believe we are strongly positioned for the coming decade, especially as demand for our facilities will continue to outgrow supply.
>
> Our research shows us that the hospitality business is a good business, and will remain so for as far as we can see. We look forward to the fututre and see continued growth, development, and profitability.

chapter 6

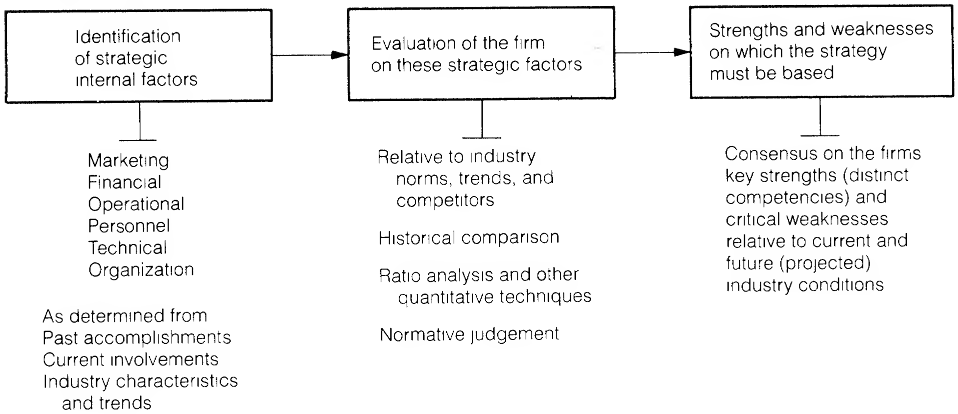
The company profile: Internal analysis of the firm

THE formulation of an effective strategy is predicated on a clear definition of company mission, an accurate appraisal of the external environment, and a thorough internal analysis of the firm. For a strategy to succeed, at least three ingredients are critical. First, the strategy must be *consistent* with conditions in the competitive environment. Specifically, it must seek to pursue existing and/or projected opportunities while minimizing the impact of major threats. Second, the strategy must be *realistic* in terms of the requirements it places on the firm's internal resources and capabilities. In other words, the firm's pursuit of market opportunities must be based on key internal strengths and not solely on the existence of market opportunity. Finally, the strategy must be *carefully executed.* The focus of this chapter is on the second ingredient for strategic success: realistic analysis of the firm's internal capabilities.

Internal analysis is a difficult and challenging task. The internal analysis leading to a realistic company profile frequently involves trade-offs, value judgments, and educated guesses as well as objective, standardized analysis. Students experience this dichotomy in their case analysis and preparation for business policy courses. Unfortunately, the fact that this dichotomy exists often leads managers to slight internal analysis with an unbalanced emphasis on personal opinion. The process of systematic internal analysis leading to an objective company profile is an essential building block in the development of a realistic, effective strategy.

Figure 6–1 illustrates the process of internal analysis. The purpose of internal analysis is to identify the strategically important strengths and weaknesses on which the firm should ultimately base its strategy. Conceptually, this purpose can be achieved by first identifying key internal factors (for example, distribution channels, cash flow, locations, technology, and organizational structure) and secondly evaluating the factors. This simple conceptualization of the manner through which strengths and weaknesses are determined is provided to accommodate discussion and, hopefully, your

figure 6–1
Internal analysis of the firm



understanding of the process of internal analysis. In actual practice, the process is far less linear and simple.[1] The three steps tend to overlap. Different managers (by position and level) approach internal analysis in different ways. Stevenson's research found that managers even use different criteria for evaluating apparent strengths and potential weaknesses.[2] In this study, managers evaluated apparent strengths on historical and relative-to-competitor bases. Potential weaknesses were evaluated from a normative, futuristic perspective. We will examine these findings in more detail later in this chapter.

While the process of internal analysis in most firms is not necessarily systematic, it is nonetheless recognized as a critical ingredient in strategy development. If only intuitive in nature, managers develop judgments about what the firm does particularly well—its key strengths or distinct competencies. And based on the match between these strengths and defined or projected market opportunities, the firm ultimately charts its strategic course.

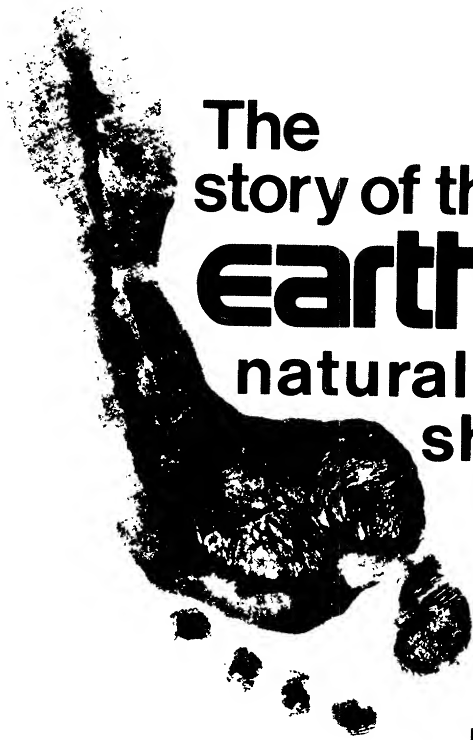
The value of systematic internal assessment

Before discussing the components of internal analysis in greater detail, we would like to illustrate the impact of systematic internal analysis. The experiences of business firms, both large and small, suggest that thorough internal assessment is critical in the development of a successful business strategy. Regardless of the favorable opportunities that exist in the environment, a firm must base its strategy upon a thorough consideration of internal

[1] Howard H. Stevenson, "Defining Strengths and Weaknesses," *Sloan Management Review*, Spring 1976, pp. 51–68.

[2] Ibid., p. 65.

figure 6-2
Kalso Earth® Shoe Company



The story of the earth® natural heel shoe

We walk in a tough world. A world made of steel and concrete. A world without sympathy for our feet!

That's why Anne Kalso invented Earth® Shoes. They're designed to create underfoot the same natural terrain that existed before the earth was paved.

Patterned in the form of a healthy footprint in soft earth, the Earth® Shoe promises unsurpassed comfort and a new way of walking.

The natural heel construction with its heel lower than the toes, provides a welcome alternative to the raised heel we have endured in the past. Lowering the heels relieves pressure on the toes and allows them to flex and spread freely.

The new, improved Earth® Shoe is lighter weight than the original, with a classic contemporary look that will always be in style with people who seek a more natural lifestyle.

Meet Anne Kalso . . .

Anne Kalso, the inventor of the Earth® natural heel shoe, grew up in Copenhagen where her interests in Yoga and other methods for self-improvement became a life-long pursuit.

During her studies and experiments, Anne Kalso observed that by flexing the foot or lowering the heel, one could achieve a physical feeling similar to that attained in the Lotus or Buddah position of Yoga. Her further observations of the Indian's noble carriage with their foot imprints in the sand, confirmed to her that nature intended people to walk with the weight of their bodies sunk low into the heels.

She began experimenting in the development of a shoe to test this principle, taking ten years to refine her designs and walking hundreds of miles in each model until she was satisfied with her creation.

"It took numerous years of hard work before I reached the final form of my shoe which takes into consideration all the natural demands of the foot and body," said Anne Kalso.

"Now I know that I have created something. It is no longer an idea in my mind, but a thoroughly tested and proven fact."

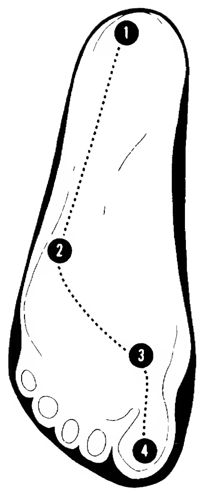
figure 6-2 *(concluded)*

about the EARTH® natural heel shoe.

Wearing the EARTH® Shoe, you will experience a completely new way of walking that might take some getting used to. Initially, you may feel off-balance because of the natural heel. This is normal so don't be alarmed. Young people adapt very quickly, older people take a little longer...

In effect, you are walking barefoot on the beach. . or across summer fields. wherever you go Because walking in EARTH® Shoes is a form of exercise, some may at first experience stiffness in the calves or thighs; some may find our unique arch may take getting used to, so moderate wear is advised in the beginning.

The uniquely contoured sole will allow you to walk in a gentle rolling motion. This helps to develop a more natural, graceful walk. There is no reason why you cannot interchange the use of other shoes with the EARTH® Shoes.

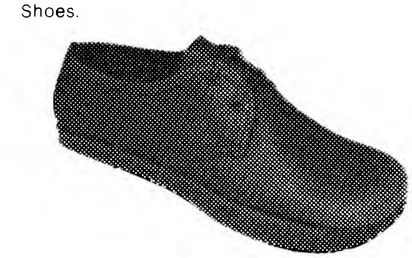


The human foot carries the entire weight load of our bodies and as we walk, this weight is constantly shifting

The first point of contact, the heel 1, takes the brunt of the load which then shifts to the outside of the foot 2 and then across the metatarsal area to the ball 3, and finally onto the large toe 4 from which we spring into our next step.

The EARTH® Shoe is specifically designed to accommodate the shifting of weight load on our feet with the greatest ease and comfort.

Another feature of the EARTH® Shoe is the unique arch support



Style 110 is the classic walking shoe. Our most popular all-around casual shoe. Available in sizes 6½ – 11 for women, and 7 – 11½ for men. Colors are Almond (medium brown) and Syrup (light tan).

Style 150 is a rugged, moccasin-toe oxford featuring an attractive closed-stitched design. Available in sizes 6½ – 11 for women, and 7 – 11½ for men. Colors are Almond and Sand Suede.

KALSØ® earth® shoe

strengths and weaknesses if such opportunities are to be maximized. Kalso Earth® Shoes and American Motors Corporation (AMC) offer useful illustrations of the value of systematic internal analysis in shaping future strategies.

Kalso Earth® Shoes was a U.S. company which started in the late 1960s selling shoes based upon the patented "negative heel" design developed in Denmark by Ann Kalso. Earth® Shoes were manufactured in Massachusetts and retailed at independent franchises throughout the United States.

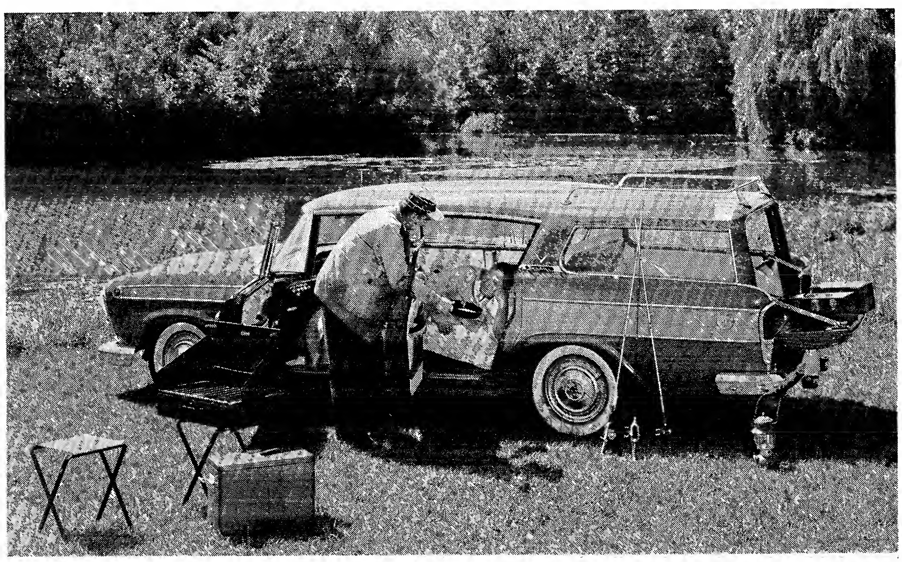
Kalso Earth® Shoes faced impressive opportunity in the demand for unique Earth® Shoes by the mid-1970s. Kalso's pursuit of this opportunity took precedent over *objective* internal analysis of its production logistics, financial capacities, and dealer organization. The single large production facility in Massachusetts encountered difficulty in managing production runs and distribution logistics to a nationwide network of small franchised outlets. Each outlet ordered directly from the factory. Frequently, styles requested by outlets differed because of local market preferences. Therefore, the Kalso plant was constantly faced with the trade-off between small, inefficient production runs or, by holding orders until efficient runs were feasible, a slow response to consumer demand. Each outlet was an autonomous distributor/retailer linked directly to the Massachusetts' production facility.

Kalso's financial structure presented additional difficulties. The company sought to finance increasing demand through short-term borrowing and the leveraging available through franchising. Kalso management desired to maintain tight control over the ownership of the firm, which they considered critical to the maintenance of quality associated with their patented, negative heel design. But faced with increasing popularity of their product and demand for franchises, Kalso's increasingly archaic financial structure was incapable of supporting such rapid growth. As a result of Kalso's production logistics, distribution system, and emphasis on short-term debt, Kalso became overextended and failed. This happened even as the demand for its negative heel design was escalating. Kalso Earth® Shoes' strategy, facing an enviable market opportunity, was not based on a systematic, objective analysis of its internal strengths and weaknesses.

AMC is the number four automaker in the United States. At three crucial times since 1954, AMC has seen its market share drop below 2 percent as it found itself competing head-on with General Motors and Ford. In 1954 AMC's outdated Hudson and Nash lines were not competitive with the bigger, more ornate GM and Ford models. The sales volume of GM and Ford provided unmatched cost advantages through economies of scale. AMC, on the verge of extinction, concentrated on a small, unserved market niche for economic cars. Identifying its internal resourcefulness, low capital investment, and a sizable (yet concerned) dealer network, AMC based the Rambler on these limited internal strengths (see Figure 6–3). In the early 1970s, again outmaneuvered by GM, Ford, and now foreign car competition, AMC examined its internal capacities. Having acquired Kaiser Jeep in early 1970, AMC's ultimate strategy was to become a jeep company. This successful

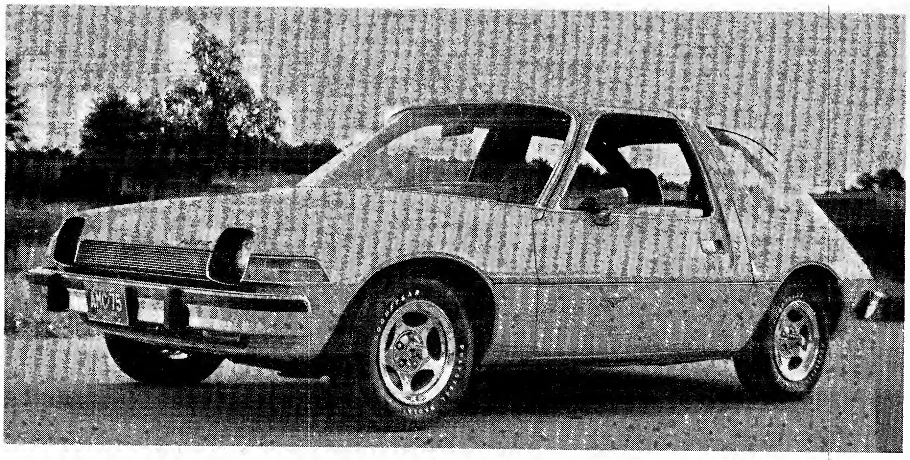
figure 6-3
AMC products in time series

A. 1954 Nash Hudson.



B. 1957 Rambler.

figure 6–3 ***(continued)***



C. 1970 Hornet Pacer.

D. 1973 Jeep.

figure 6-3 ***(concluded)***

E. 1980 Renault LeCar.

strategy was based upon limited, but critical internal competence in the production and distribution of four-wheel drive jeep vehicles. Finally, a long-term R&D relationship with Regir Nationale des Usines Renault (Renault) has become a major internal strength on which AMC's 1980 turnaround strategy, in response to the energy crisis, will be based. By 1982, Renault LeCar world compact cars will be rolling off AMC assembly lines.

American Motors Corporation faced massive environmental threats to its continued survival at three critical times since 1954. Each time, AMC management has focused objectively and intensively upon rather limited internal

strengths on which to base its subsequent strategy. In each instance, AMC has developed a successful strategy just as industry experts were finalizing AMC's obituary.

Systematic internal analysis is particularly essential in small business firms. Small firms are continually faced with limited resources and markets. At the same time, these firms have greater flexibility in making changes as well as the capability for specialized, uniquely catered responses to selected market needs. To effectively channel their limited resources in directions that maximize these limited market opportunities, it is imperative that small firms frequently engage in objective internal analysis. The case of Congress Motel, one of the *cohesion case sections* in this book, provides a vivid illustration of the critical role internal analysis plays in developing a positive foundation for a small firm's strategy.

Given these brief illustrations of the value of systematic internal analysis, it is appropriate to examine this process in more detail. Determination of strategic competencies (and weaknesses) of the firm is accomplished by identifying and then evaluating key internal factors.

Identification of strategic internal factors

What are key internal factors? Where do they originate from? How do we decide which are truly strategic factors that must be carefully evaluated? These are questions managers might raise in identifying key internal factors which they seek to evaluate as strengths or weaknesses. In the business policy course, you need the answers to these questions to guide your analysis of business and industry situations.

Key internal factors are basic capabilities, limitations, and characteristics of the firm. Figure 6–4 provides a list of typical factors, some of which would be the focus of internal analysis in most business firms. This list of factors is broken down along functional lines.

figure 6–4
Key internal factors: Potential strengths and weaknesses

Marketing:

1. Firm's products/services; breadth of product line.
2. Ability to gather needed information about markets.
3. Market share or submarket shares.
4. Product/service mix and expansion potential; life cycle of key products; profit/sales balance in produce/service.
5. Channels of distribution.
6. Effective sales organization; knowledge of customer needs.
7. Concentration of sales in a few products or to a few customers.
8. Product/service image, reputation, and quality.
9. Imaginative, efficient, and effective sales promotion and advertising.
10. Pricing strategy.
11. Producers for digesting market feedback and developing new products/services or markets.
12. Aftersale service and follow-up.
13. Goodwill/brand loyalty.

figure 6–4 ***(concluded)***

Finance and accounting:

1. Ability to raise short-term capital.
2. Ability to raise long-term capital: debt, equity.
3. Corporate-level resources (multibusiness firm).
4. Cost of capital relative to industry and competitors.
5. Tax considerations.
6. Relations with owners, investors, and stockholders.
7. Leverage position: Capacity to utilize alternative financial strategies such as lease or sale and leaseback.
8. Cost of entry and barriers to entry.
9. Presence of financial planning and budgeting practices.
10. Working capital.
11. Effective cost control; ability to reduce cost.
12. Financial size.
13. Efficient and effective accounting system for cost, budget, and profit planning.

Production/operations/technical:

1. Raw materials cost and availability.
2. Inventory control systems.
3. Location of facilities.
4. Layout and utilization of facilities.
5. Technical efficiency of facilities and utilization of capacity.
6. Effective use of subcontracting.
7. Degree of vertical integration: value added and profit margin.
8. Efficiency and cost/benefit of equipment.
9. Effective operation control procedures: design, scheduling, purchasing, quality control, and efficiency.
10. Costs and technological competencies relative to industry and competitors.
11. Research and development/technology/innovation.
12. Patents, trademarks, and similar legal protection.

Personnel:

1. Management personnel.
2. Employee's skill and morale.
3. Labor relations/costs compared to industry and comeptition.
4. Efficient and effective personnel policies.
5. Effective use of incentives to motivate performance.
6. Aiblity to level peaks and valleys of employment.
7. Employee turnover and absenteeism.
8. Specialized skills.
9. Experience.

Organization/general management:

1. Organizational structure.
2. Firm's image and prestige.
3. Firm's record for achieving objectives.
4. Organization communication system.
5. Overall organizational control system effectiveness and utilization.
6. Organizational climate.
7. Use of systematic procedures and techniques in decision making.
8. Top management skill, capabilities, and interest.

Firms are not likely to consider all of the factors in Figure 6-4 as potential strengths or weaknesses. To develop or revise a strategy, managers would rather seek to identify the few strategic factors on which success will most likely depend. Equally important, the reliance of these different internal factors will vary by industry, market segment, product life cycle, and the firm's current position. Strategists are looking for what Chester Barnard calls "the strategic factors," those internal capabilities that appear most critical for success in a particular competitive area.[3] And the strategic factors for firms in the oil industry will be quite different from the strategic factors of firms in the construction or hospitality industries. The strategic factors can also vary between firms within the same industry. In the mechanical writing industry, for example, the strategies of BIC and Cross, both successful, are based on different internal strengths. BIC's strategy is based on its strengths in mass production, extensive advertising, and mass distribution channels. Cross's strategy is based on high quality, image, and selective distribution channels.

How do we identify which factors are strategic factors that will subsequently require close evaluation? This is done by reviewing the firm's past performance, current involvement, and the industry characteristics/trends both in terms of current product/markets and contemplated product/markets.

Strategists examine past performance seeking to isolate the key internal contributors to favorable (or unfavorable) results. What did we do well, or poorly, in marketing, operations, and financial management that had a major influence on past results? Was the sales force effectively organized? Were we in the right channels of distribution? Did we have the financial resources to support the past strategy? The same examination and questions can be applied to current involvements with particular emphasis on the changes in the importance of key dimensions over time. At BIC Pen Company, for example, heavy advertising along with mass production and mass distribution were strategic internal factors for BIC's initial strategy in ball-point pens and disposable lighters. With the product life cycle fast reaching maturity, BIC currently has determined that cost-conscious mass production is a strategic factor while heavy advertising is not.

Analysis of past trends in sales, costs, and profitability is of major importance in identifying strategic internal factors. Identification of key internal factors should be based upon a clear picture of the nature of the firm's sales. An anatomy of the firm's past sales trends broken down by product lines, channels of distribution, key customers or types of customers, geographic region, and sales approach should be developed in detail. A similar anatomy should be developed that focuses upon costs and profitability. Detailed investigation of the firm's performance history in this manner should isolate

[3] Chester Barnard, *Functions of the Executive* (Cambridge, Mass.: Harvard University Press, 1939), chap. 14.

strategy in action, 6–1

Changing Strengths and Weaknesses at Prime Computer Co.

Prime Computer Company (PCC) is undergoing a serious reevaluation of its internal strengths and weaknesses upon entering the 1980s. Kenneth Fisher, PCC president, said, "we don't have the edge we had five years ago," in a recent interview with *Forbes* magazine.

What he's talking about is superminicomputers, small mainframes called 32-bit machines within the computer industry. "Five years ago our machines gave 10 times the performance for the same price; now it's a 2-to-1 price/performance advantage," Fisher offered in the *Forbes* interview.

The company was formed in 1972 by ex-Honeywell computer personnel, specializing in computer software product techniques. Buoyed by R&D funding from MIT and NASA for six years, PCC became a technologically advanced mainframe manufacturer for superminis. Its sales reached $11.4 million by 1975. Since Fisher became president in 1975, sales have risen to $153 million in 1979, net income from $.7 million to $17 million, with a projected $20 million profit in 1980.

The strengths on which PCC's past strategy and performance were based appear quite different from what Fisher must work with today. The PCC that produced the figures above is a different company from PCC today. PCC was a technically superior company, making a superior product, but in search of the right market. Today it's a marketing company, selling a product whose edge over compeitition has been substantially eroded. Approximately 60 percent of its work force is in marketing versus only 5 percent in 1975.

Technical superiority has declined in the face of the recent series of supermini entries from major computer firms like Digital Equipment and IBM. R&D, formerly subsidized by MIT and NASA, has only recently received 10 percent of sales funding, which is common in the industry. The absolute amount is miniscule compared to R&D budgets at major computer firms.

When Fisher came to PCC, its marketing was in trouble. According to Fisher, "The product was good, but it had too many bells and whistles, it was too powerful for their chosen market, and too cheap. That will get you in trouble quick."

Fisher changed that. "PCC has 500 salesmen in the United States and abroad, with efforts targeted toward the business and professional mar-

strategy in action, 6–1 ***(concluded)***

ket, beautifully packaged products, selling at higher prices than the total market ($150,000 versus $86,000)," according to the *Forbes* interview.

Even so, PCC's revenue per salesperson declined 16 percent in 1980. PCC carries virtually no backlog (delivery within 60 days), while Digital Equipment has almost a one-year backlog of orders.

PCC is still a major force (15 percent market share) in a rapidly growing market. But its future strategy must reflect its changing strengths and weaknesses if success is to be maintained and revitalized.

Source: "We Knew We Couldn't Hold Our Lead," *Forbes*, December 22, 1980, p. 46.

internal factors (influencing sales, costs, profitability, or their interrelationships) of major importance to future strategy decisions. For example, one firm may find that 83 percent of its sales result from 25 percent of its products. Another firm may find that 30 percent of its products (or services) contribute 78 percent of its profitability. In seeking to understand such results, a firm may determine that certain key internal factors (for example, experience in particular distribution channels, pricing policies, warehouse location, technology) deserve major attention in formulating future strategy.

Identifying strategic factors requires an external focus as well. In trying to isolate key internal factors from an analysis of past and present performance, the strategist uses industry conditions/trends and comparisons with competitors to provide interpretive insight. BIC's identification of mass production and advertising as key internal factors for subsequent evaluation is based as much on its analysis of industry and competitive characteristics as it is on past performance within BIC itself. Furthermore, in isolating strategic internal factors for in-depth evaluation, firms are often contemplating expansion of products, markets, diversification, and so forth. Clearly, scrutinizing the industry under consideration as well as its current competitors becomes a key means for identifying strategic factors when the firm is seeking to evaluate its capability to move into heretofore unfamiliar markets.

Evaluation of strategic internal factors

We have separated identification and evaluation (of key internal factors) for discussion purposes, but in practice they are not separate, distinct steps. And this is as it should be. For the objective of internal analysis is to carefully determine the strategic strengths and weaknesses of the firm. The internal analysis that generates a long list of resources and capabilities has provided little help in strategy formulation. To facilitate effective strategy formulation, internal analysis must identify and evaluate the limited strengths and weaknesses a firm possesses relative to the opportunities targeted in its current and future competitive environment.

What are strengths and weaknesses? A factor would be considered a strength when it is a distinct competency or competitive advantage that the firm possesses. It is more than merely what the firm has the competence to do. It is something the firm does (or has the future capacity to do) particularly well relative to existing or potential competitors. The importance of distinctive competence (strengths) rests with the unique capacity it gives an organization in developing a comparative advantage in the marketplace.[4] Kalso Earth® Shoe's product image and patented design were two distinct competencies for that firm.

A factor would be considered a weakness when it is something the firm does poorly, or doesn't have the capacity to do while the capacity does exist for key rivals. Centralized production facilities and lack of capital resources were major weaknesses for Kalso Earth® Shoes in trying to compete with other shoe manufacturers on a nationwide basis. Scripto's outdated production facilities and lack of financial resources to support mass advertising were major weaknesses Scripto management had to weigh in their decision to challenge BIC in the ball-point segment of the mechanical writing industry.

How should strategists evaluate strengths and weaknesses? A major focus in determining a firm's strengths and weaknesses is comparison with existing (and potential) competitors. Firms in the same industry often have different marketing skills, financial resources, operational facilities and locations, different technical know-how, brand image, levels of intergration, managerial talent, and so on. These different internal capabilities can become relative strengths (or weaknesses) depending upon the strategy the firm chooses to pursue. To facilitate the appropriate choice of strategy, the strategist should compare its key internal capabilities with those of its rivals in order to isolate key strengths or weaknesses.

In the major home appliance industry, for example, Sears and General Electric are major rivals. Sears's major strength is its sizable retail network. For GE, distribution—through independent franchised dealers—has traditionally been a relative weakness. With its sizable financial resources to support modernized mass production, GE has maintained both a cost and technological advantage over its rivals, particularly Sears. While a major strength for GE, this is a relative weakness for Sears since it depends solely on subcontracting to produce Kenmore appliances. Maintenance and repair service is another important consideration in the appliance industry. Historically Sears has derived a strength on this dimension because it can maintain a fully staffed service component and spread the costs over numerous departments at each location. GE, on the other hand, has had to depend on regional service centers and local contracting with independent service firms. In ultimately developing a strategy, distribution network, technologi-

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[4] A. A. Thompson and A. J. Strickland, *Strategy and Policy: Concepts and Cases* (Plano, Tex. Business Publications, 1981), p. 54.

cal capabilities, operating costs, and service facilities are a few of the internal factors Sears and GE must consider. To ascertain whether their internal capabilities on these and other factors are strengths or weaknesses, comparison relative to key competitors can provide useful evaluative insight. And significant favorable differences between the firm and its major competitors (existing and/or expected) have the potential to be the cornerstone of the firm's strategy.

Similar to competitor analysis, strategists contemplating entering a new industry or industry segment seek to identify the key determinants of success for that industry. Scrutinizing industry competitors, as well as customer needs, vertical industry structure, channels of distribution, costs, barriers to entry, and so on, the strategist seeks to determine if its current internal capabilities represent strengths in these new competitive arenas. General Cinema Corporation, the nation's largest movie theater operator, determined that its internal skills in marketing, site analysis, creative financing, and management of geographically dispersed operations provided key strengths relative to the soft-drink bottling industry. Since entering this industry in 1968. General Cinema has become the largest franchised bottler of soft drinks (handling Pepsi) in the United States.

In addition to industry/competitor comparison, strategists also use the historical experience of the firm as a basis for evaluating internal factors. Managers are most familiar with their firm—its internal capabilities and problems. These managers have been immersed over time in the management of the firm's financial, marketing, production, and R&D activities. Not surprising, their determination of whether certain internal factors—like production facilities, sales organization, financial capacity, control systems, and key personnel—are either strengths or weaknesses will be strongly influenced by this internal experience. In the capital-intensive airline industry, for example, debt capacity is a strategic internal factor. Delta, for example, has a debt/equity ratio of .15, while Braniff's is 5.2. Frank Borman, president of Eastern Airlines, considers Eastern's ratio of 2.1 to be an emerging strength for the firm. While obviously aware of competitive comparisons, he bases this evaluation on the historical experience of Eastern—the fact that the ratio has improved since he joined the firm in 1975, from 4.1 to its current 2.1 level.[5]

While historical experience can provide a relevant evaluation framework, strategists must be careful to avoid tunnel vision. Texaco management, for example, has long considered its large number of Texaco brand service stations (27,000 in 1980) to be a key strength. This strength (along with other perceived strengths) had "worked so well for so long [at Texaco] that even the thought of changing them was heretical to management."[6] But Shell,

[5] Eastern Airlines, Inc., *1979 Annual Report,* p. 5.

[6] "Texaco: Restoring Luster to the Star," *Business Week,* December 22, 1980, p. 54; and "Inside the Shell Oil Company," *Newsweek,* June 15, 1981, p. 74.

strategy in action, 6–2
Firestone Examines Its Strengths and Weaknesses

Firestone Tire & Rubber Company has finally turned around. Or so John J. Nevin, the company's president, believes. In 1979, recruited from Zenith Radio Corporation to get the troubled number 2 tire maker back on track, Nevin was less sanguine. He was alarmed by "the terrible load of excess and obsolescent plant capacity we were carrying." He saw Firestone suffocating in a glut of unsold tires that had used all its cash and much of its credit to produce.

Firestone's trauma was just one of those visited upon American industry by sharply higher energy costs. For Firestone, the trouble was complicated by a tire recall, the largest in its history, that began in late 1978 and cost the company more than $155 million, about 75 percent of the cost of a modern tire plant.

In Nevin's view, Firestone management had acted as though the tire industry had suffered only a temporary slump. Instead, he says, the industry and its market was becoming permanently smaller. He observes that smaller, lighter new cars need only 75 pounds of tires each, instead of 150 pounds. Imported cars, each equipped with five foreign tires, are taking a growing share of the U.S. market. People are driving less because gasoline costs more and because smaller cars are less comfortable on long trips. New cars come equipped with radial tires, which will run twice as far as bias tires, the old industry standard.

While tire demand was falling, Firestone had kept its unused capacity for producing bias tires. Management had expected a rebound in sales and wanted Firestone to keep its capacity to exploit the market when competitors dropped out. But the new forecasts meant that Firestone's overcapacity would become an enormous burden.

At a directors' meeting in March 1980, Nevin presented a drastic remedy, the shutdown of five aging U.S. tire plants and one in Canada that together accounted for more than one third of Firestone's North American car-tire and truck-tire capacity.

Shutting down the plants automatically worked to cut Firestone's big inventory. But Nevin decided to go further and reduce the number of products, too. In April, Firestone was turning out 7,289 different types, sizes, and brands of tires—5,472 of them required for private label and secondary-brand customers that accounted for only 35 percent of the company's North American tire sales. The number of different types has been trimmed to 4,895. It will be reduced more.

strategy in action, 6–2 ***(concluded)***

That action restored some of the glow to Firestone's pallid balance sheet. From October 1977 to April 1980, the North American tire group's inventories had risen by some $230 million, creating an increase in Firestone's debt of almost $200 million. By April, debt exceeded 80 percent of shareholders' equity in the company, way above the 50 percent that Nevin believes should be tops. Since then, reduction in tire inventories has freed $280 million. Most of that money has been used to reduce debt, which has fallen to 64 percent of the shareholders' equity. Nevin says he still intends to bring debt down to the 50 percent of equity target.

Meanwhile, Firestone's remaining plants are expected to operate far more profitably at 90 percent or more of capacity in the 1981 fiscal year. In fiscal 1980, Nevin says, the plants ran at less than 70 percent of capacity.

Nevin engineered other big moves in fiscal 1980. Administrative and sales staffs were cut to 9,900 people from 12,250 for a $25 million-a-year cost reduction. He agreed to sell Firestone's plastics division for about $200 million in cash to Occidental Petroleum Corp. "Firestone would have had to invest another $150 million to $200 million to stay competitive in the plastics business, and if we had done that, we would have had to starve our other businesses," Nevin says, "We are a company with extraordinary skills and strengths, but I don't think plastics was a well-advised battlefield for using those skills and strengths."

"The improved balance sheet becomes a stepping stone to the future," he says. "We have an objective of diversifying, but there isn't any sense in talking about diversifying if you don't have the internal strengths."

Source: "Firestone Becomes Leaner and Stronger by Cutting Capacity, Jobs, Product Lines," *The Wall Street Journal,* November 19, 1980, p. 37.

with just over 6,280 service stations, now sells slightly more gasoline than Texaco does.[7] Clearly, using only historical experience as a basis for identifying strengths and weaknesses can prove dangerously inaccurate.

Numerous quantitative tools are available to help evaluate selected internal capabilities of the firm. These entail the measurement of the firm's effectiveness vis-à-vis each relevant factor and comparative analysis of this measurement with both competitors (directly or through industry averages) and the historical experience of the firm. Ratio analysis is one example. Ratio analysis provides a useful tool for evaluating selected financial, marketing, and operational factors. The firm's balance sheet and income statement represents an important source to derive meaningful ratios. Figure 6–5 provides several ratios that examine financial, operational, and marketing-

[7] "Texaco," p. 60.

figure 6-5
Selected ratios for internal evaluation

Financial:

$$\text{Debt ratio} = \frac{\text{Long-term debt}}{\text{Net worth}}$$

(The debt ratio reflects the firm's debt posture and provides an indication of the firm's ability to raise additional long-term debt.)

$$\text{Profit to sales} = \frac{\text{Net profit}}{\text{Sales}}$$

(This ratio, often compared to industry average, identifies the percentage of sales revenue retained as net earnings to the firm. It is a frequently used barometer of the cost/price effectiveness of firm operations.)

$$\text{Breakeven point} = \frac{\text{Fixed cost}}{\text{Contribution margin}}$$

(The breakeven point is very useful in internal analysis. It shows at what volume level the firm covers fixed costs and facilitates examining how changes in volume, cost, or price will affect profitability.)

Marketing:

$$\text{Sales effectiveness ratio} = \frac{\text{Sales}}{\text{Number of sales people}}$$

(An indication of the relative effectiveness of the sales organization.)

$$\text{Advertising utilization ratio} = \frac{\text{Advertising and promotion costs}}{\text{Total sales}}$$

(Through comparative analysis, this ratio provides an indication of promotion emphasis and effectiveness.)

Operational:

$$\text{Asset turnover ratio} = \frac{\text{Sales}}{\text{Assets}}$$

(An indicator of operating effectiveness in the use of the firm's resources.)

$$\text{Inventory turnover} = \frac{\text{Net sales}}{\text{Average annual inventory}}$$

(An indicator of the effective coordination between marketing and operating activities.)

related factors. Numerous sources present extensive treatment of the calculation and interpretation of selected ratios.[8]

[8] G. Foster, *Financial Statement Analysis* (Englewood Cliffs, N.J.: Prentice-Hall, 1978); J. O. Horrigan, *Financial Ratio Analysis: A Historical Perspective* (New York: Arno Press, 1978); Baruch Lev, *Financial Statement Analysis: A New Approach* (Englewood Cliffs, N.J.: Prentice-Hall, 1974); and J. F. Weston, and E. F. Brigham, *Essentials of Managerial Finance*, 5th ed. (Hinsdale, Ill.: Dryden Press, 1979).

Dun & Bradstreet[9] as well as Robert Morris Associates[10] regularly publish sets of ratios for a variety of industries. Trade publications for specific types of firms represent another source of information. Ratio information from these sources and the firm's past performance provide a useful reference with which to employ the tool of ratio analysis in evaluating an internal factor. Examples of other quantitative or analytical tools that can be used include cash flow analysis, sensitivity analysis, elasticity and variability analysis, and the product life-cycle concept.[11]

The use of quantitative tools does not apply to all internal factors. Many internal factors must be evaluated as strengths or weaknesses based upon the normative judgments of key planning participants. Company (or product) image and prestige is an example of one internal factor more conducive to qualitative evaluation. Even though the evaluation is qualitative and judgmental, the identification and serious evaluation of this type of factor is a necessary and important aspect of a thorough internal analysis of the firm. Research by Harold Stevenson found this to be particularly true in evaluating weaknesses.[12] Interviewing 50 executives in six medium to large business firms, he found the following types of criteria used to identify and evaluate strengths and weaknesses:

Type of criteria	*Degree of use (percent) in evaluating*	
	Strengths	*Weaknesses*
Historical experience	90	10
Industry/competitor comparison	67	33
Normative judgment	21	79

While managers used past performance and competitive comparison in evaluating tentative strengths, they relied heavily on normative judgment (qualitative assessment and opinion) in evaluating probable weaknesses.

[9] *Dun's Review* (New York: Dun & Bradstreet, monthly).

[10] *RMA: Annual Statement Studies* (Philadelphia: Robert Morris Associates, annually).

[11] Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980) offers broad, in-depth coverage of numerous analytical techniques for evaluating the strengths and weaknesses of a firm and its competitors; Philip Kotler, *Marketing Management* (Englewood Cliffs, N.J.: Prentice Hall, 1980), chap. 12, provides a straightforward treatment of the uses, pros, and cons of the product life-cycle concept; D. M. Joy, *Introduction to Financial Management* (Homewood, Ill.: Richard D. Irwin, 1980), pp. 119–28, 207–9, provides a useful discussion of cash flow analysis and sensitivity analysis; and C. W. Hofer, and D. Schendel, *Strategy Formulation: Analytical Concepts* (St. Paul, Minn.: West Publishing, 1978), especially chap. 2, provides an illustrative discussion of sensitivity analysis, elasticity analysis, variability analysis, and the product life-cycle concept as tools for evaluating a business's strengths and weaknesses.

[12] Stevenson, "Defining Strengths," pp. 64–68.

Stevenson suggests that this use occurs because weaknesses often reflect competences or areas in which the firm (and its managers) lack experience. Without this experience to draw on in comparing the firm to competitors or its own past performance, management is left with qualitative assessment and opinion as a basis for evaluating the weakness. Stevenson's research probably does not reflect how all business firms evaluate strengths and weaknesses, but it provides a vivid illustration of the frequency with which typical managers employ normative judgments in the internal analysis of strengths and weaknesses.

Linking strengths and weaknesses to the overall strategic management process

This chapter began by illustrating the role of internal analysis within the overall strategic management process. Internal analysis does not take place in a vacuum. It is dependent upon other aspects of the strategic management process. Perhaps most critical is the relationship between internal analysis and environmental assessment. Environmental assessment, particularly as it

figure 6–6
Matching internal analysis and environmental assessment

Internal analysis of the firm	*External assessment of the environment*	
	Opportunities	*Threats*
Strengths	1	2
Weaknesses	3	4

Cell 1: Most favorable area for the firm's strategy to emanate from. Allows the best firm-environment match and the greatest likelihood of success through rapid growth.

Cell 2: Typically firm's in mature markets, facing major impediments to increased market share, which can lead to profit maximization, favorable short-term cash flow, or retrenchment and slow decline.

Cell 3: Ideal area to develop turnaround strategies for the firm. The key here, through strategic management, is to seek substrategies that turn weaknesses into strengths. Also an area for retrenchment, survival, or decline.

Cell 4: A critical, threatening area in which to operate. Frequently calls for retrenchment, divestiture, or exit.

focuses on competitors, product/market trends, consumer preferences, technological changes, and changing industry structure, provides the critical basis with which strategists can evaluate internal factors and identify key strengths and weaknesses. And this relationship is important for another reason: Matching internal strengths and weaknesses with environmental opportunities and threats is an essential step in the generation of viable alternative strategies for the firm. Figure 6–6 illustrates the framework within which this matching will occur. This process will be discussed in Chapter 8. It is presented to illustrate the important contribution an accurate company profile can make in facilitating the choice of an effective strategy for the firm. Different patterns of internal strengths and weaknesses lead to very different strategy options for the firm, as you can see in Figure 6–6. Clearly the accuracy of internal analysis in identifying key strengths and weaknesses is of critical importance in ultimately identifying the best strategy for the firm.

strategy in action, 6–3

Jenn-Air Turns Weaknesses into Strengths by Selling Out

On October 1978, Carrier Corporation agreed to acquire Jenn-Air Corporation, an Indianapolis-based maker of electric ranges. Jenn-Air had performed impressively in the past. From 1973–1977, its earnings had jumped eightfold to $45 million. Morever, the company had carved out a secure niche in the high-priced end of the $1.2 billion electric range market by manufacturing innovative product lines. In fact, Jenn-Air's performance had been so strong that its agreement to merge with Carrier surprised most observers.

The Jenn-Air sell-out strategy seems designed to get the company extra money and marketing muscle. Carrier, which had revenues 25 times greater than Jenn-Air, promised financial backing, manufacturing know-how, and management expertise. These resources were needed as Jenn-Air's fast growth inevitably brought the company into more direct competition with larger range makers, including GE, Tappan, Roper, and Magic Chef.

Ventilation technology had been Jenn-Air's cornerstone, and because it was ready to expand its market, Carrier's support could be crucial. Since Jenn-Air's new grill range needed no costly duct work, it could be installed easily in older houses and multifamily units, such as apartments. Although this huge market was unfamiliar to Jenn-Air, it was not new to Carrier, the air-conditioning specialists.

Source: Based on the article "Jenn-Air: Being Acquired to Expand Even Further," from the October 18, 1978 issue of *Business Week*.

Summary

The company profile is a critical dimension of the strategic management process. The company profile is developed by engaging in a thorough internal analysis of the firm. Internal analysis starts with the identification of strategic factors within the firm that impact firm effectiveness. Identification of key internal factors is developed through an in-depth analysis of performance history, current involvements, and the firm's existing or potential competitive environment.

The second phase of internal analysis is the thorough evaluation of key factors which the strategists have identified. Historical experience and industry/competitor comparison provide the two key frameworks for evaluating these strategic factors. Technical or quantitative tools, such as ratio analysis and the product life cycle, are often used to facilitate this comparative evaluation. Normative judgments are often called for in this evaluation phase, particularly where strategists lack the technical capacity or comparative knowledge for evaluation.

Internal analysis, while focusing inward, is critically dependent on environmental assessment for relevance and accuracy. The ultimate purpose of internal analysis is to isolate strategic strengths and weaknesses around which to build the firm's future strategy.

Questions for discussion

1. Describe the process of identifying key internal factors for a firm's strategic management endeavor? Why does this appear to be an important part of the strategic management process?
2. Apply the two broad steps of internal analysis to yourself and your career aspirations? What are the major strengths and weaknesses you possess? How might these be used to develop your future career plans?
3. Select one business in your area that appears to be doing well and one that appears to be doing poorly. Form two small teams with the help of your instructor. Have each team take one of the businesses and schedule a brief interview with a key manager.

   Obtain a *specific* assessment of the firm's internal strengths and weaknesses from a key manager. Compare the results in a subsequent class. Are there substantial differences? Is one more comprehensive and specific than the other? Do strengths and weaknesses vary by type of business?
4. Explain why a firm might emphasize historical experience over competitor comparison in evaluating its strengths and weaknesses? When would the reverse emphasis be more relevant?

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chapter 6 cohesion case
Internal analysis at Holiday Inns, Inc.

Internal analysis at Holiday Inns must take place in two parts: on the business level and on the corporate level. First, you should examine the strengths and weaknesses within each business group. After these analyses have been completed, they should be pulled together in an integrated overview of the strengths and weaknesses which Holiday Inns possesses as a multibusiness firm.

Hotel group. Clearly, this is the key business group for internal analysis. The hotel group is the core of Holiday Inns' diversified operations. It provides over 54 percent of total corporate revenues and over 74 percent of corporate income before taxes. Based on the case material and the lodging industry note, the strengths and weaknesses of the hotel group are shown in Exhibit 1.

Transportation group. This is a growing segment of Holiday Inns, Inc.'s overall corporate endeavor. Two rather different businesses make up the transportation group—Continental Trailways bus system and Delta Steamship. Trailways seeks to provide moderate- to low-priced domestic intercity travel, while Delta provides marine cargo service and, increasingly, oceanic

pleasure cruises. Based on the case material, the strengths and weaknesses of this business group are outlined in Exhibit 2.

Products group. The products group originated as an ancillary service to parent-owned and franchise hotels/motels to ensure standardization of fur-

exhibit 1
Hotel group: Internal analysis

Strengths	*Weaknesses*
1. HI dominates the industry in number of rooms available. It has the largest market share of lodging revenue dollars. (Exhibit 1)	1. Increasing average age of the typical property foretells increased maintenance and renovation expense. **(15)**
2. Name, image, and customer awareness. **(6, 91)**	2. Dependent on traveling public, which is facing steadily increasing gasoline prices. **(102)**
3. Computerized reservation system, Holidex, has traditionally been a major advantage although competitors—Best Western, Ramada, Days Inns—are about equal now. **(24)**	3. Hotels/motels are energy wasters which can disturb margins in an era of rapidly increasing energy costs. **(102)**
4. Extensive and steadily growing franchise network (80 percent of all units) with franchise revenues inflation-immune since they are based on a percentage of gross revenues. **(16)**	4. HI has become the moderate to high-priced accommodation relative to the rapidly expanding budget chains. **(Exhibit 10, 92)**
5. Massive real estate holdings rising steadily in value providing an expanding asset base. Also, older mortgage rates provide a relative advantage against the cost newer competitors must encounter. **(Exhibit 12)**	5. A maturing domestic lodgings industry with limited expansion opportunities as evidenced by the net decline in the number of company-owned facilities over the last five years. **(Exhibit 10)**
6. Accumulated lodging experience both domestically and abroad. Extensive managerial talent and resources as evidenced by franchisee Winegardner's move to the top. **(6, 69–78, 91)**	6. Sensitivity to economic downturns as people curtail pleasure travel. **(102, 103)**
7. Steadily improving occupacy rate, revenues per room, gross revenue, and profit margin. **(88, Exhibit 10)**	7. Rapidly escalating price competition on the one end (Days Inn, Best Western) and quality competition (Hilton, Marriett, Hyatt) on the other cuts at HI's large middle market. Also, relative to price competition, HI's built-in overhead—like 16-hour restaurants, big lobbies, room service—limit flexibility in lowering operating margins. **(Exhibit 1, 92)**

exhibit 1 ***(concluded)***

Strengths	*Weaknesses*
8. Well-balanced locations for interstate, airport, resort, and downtown traveler needs. **(12, 15, 91)**	8. Cash drain on hotel group to support corporate-level overhead and ventures into new areas. Relatedly, attitude of franchises regarding use of their fees to support this versus occupancy-enhancing activities. **(Exhibit 11)**
9. Quality control system. **(26–28)**	9. Challenges to the franchise agreement and relative dependence on franchisees. **(18, 21, 16)**
10. Food and lounge facilities at every location. **(91)**	

nishings and equipment and to recoup the overhead paid out to independent suppliers. It has grown to be the leading supplier of institutional products and related design services in the hospitality industry, primarily because the hotel group has a heretofore captive market. Its strengths and weaknesses are shown in Exhibit 3.

Other groups: Restaurants and casinos. In late 1978 and early 1979, Holiday Inns, Inc. moved into the freestanding restaurant market with its purchase of

exhibit 2
Transportation group: Internal analysis

Strengths	*Weaknesses*
1. Increasing gasoline prices and threats of oil embargos should bolster ridership on Trailways. Additionally, Trailways' riders could complement hotel operations, especially from tour and charter services. **(37, 38)**	1. Major competition from Greyhound, the number one bus line, as well as air and train transportation. **(97)**
2. Second largest domestic bus service. **(35)**	2. Questionable whether the typical Trailways passenger is the typical HI motel/hotel customer. **(38, 97)**
3. Steady increase in transportation group revenues, particularly package express services. **(39)**	3. Rising maintenance and energy-related costs while at the same time engaging in a price war with Greyhound. **(97, 102)**
4. Steady increase in net bus income, although no improvement in income as percent of revenues and a major drop within the steamship component. **(35, Exhibit 7)**	4. Privately owned and maintained terminal facilities instead of the municipally owned terminals airlines enjoy. **(97)**

exhibit 2 ***(concluded)***

Strengths	*Weaknesses*
5. Delta Steamship (cargo) represents an operating base not directly tied to vacation and business travel. **(41)**	5. Condition and rising maintenance/replacement costs of Trailways bus terminals. **(97)**
6. Cargo business, with strong presence in South American and African routes, foretells a solid presence to serve U.S. exports to Third World countries. **(41, 42, 12)**	6. Growing popularity of airlines for both leisure and business travel based on a price/time in transit comparison. **(97)**
7. LASH technology is a distinct cargo cost advantage. **(41, 46)**	7. Extent of managerial expertise in transportation—bus and marine cargo—is rather limited. **(69–78, 45)**
8. Passenger service is a high-margin business. **(43)**	8. Heavy capital investment in marine cargo and oceanic passenger business. **(Exhibit 8)**
	9. Small market share in marine transport and oceanic passenger markets. **(45, 46)**
	10. Lack of clear synergy between Delta operations and Trailways or both and the hotel group.

exhibit 3
Products group: Internal analysis

Strengths	*Weaknesses*
1. Vast, company-owned, and franchisee captive market, especially to the extent franchisees can be required to purchase from Inn Keepers, Dohrmann, and Innkare. **(29–31)**	1. Resistance from franchisees to being forced to buy from Inn Keepers, Dohrmann, and Innkare. **(18)**
2. Stable institutional market with growth potential in health care segment. **(30–33, 90)**	2. A captive, intracompany business more than an independent, competitive, institutional supplier. **(31–33, 90)**
3. Long-term experience in the design and supply of food and lodging equipment and furnishings. **(33)**	3. Consistently low-profit margins. **(Exhibit 6)**
4. Logical synergy with the hotel group. **(31, 90)**	4. Revenue has not increased significantly in over five years **(Exhibit 6)**

Perkins Cake and Steak, Inc. and its joint venture into casino operations in Atlantic City and Las Vegas. Since these are new business groups, the case material is rather limited. You are encouraged to seek outside information—such as *Moody's, Standard & Poor's Industry Surveys*—to round out your assessment of strengths and weaknesses here. Tentative strengths and weaknesses we see are listed in Exhibit 4.

exhibit 4
Restaurant and gaming groups: Internal analysis

Strengths	*Weaknesses*
Restaurants:	*Restaurants:*
1. Perkins provides an immediate presence in the freestanding restaurant business via 360 company-owned and franchised operations in 30 states. **(table 1, p. 38)**	1. Must be integrated into a growingly complex and diversely focused corporate management.
2. HI is experienced in restaurant operation.	2. Faces stiff competition from similar firms like Sambo's, Shoney's, Denny's, and fast-food firms like McDonald's, Burger King, and Wendy's. **(100)**
3. Perkins is positioned as a family restaurant with a customer profile quite similar to the HI hotel guest. **(53)**	3. Limited geographic emphasis—northern United States. **(51)**
4. It is a franchise-based business, again deriving synergy from past experiences and hotel expertise at HI. **(52)**	
5. Provides economy of scale advantage in purchasing and advertising with restaurant business. **(57)**	
Casinos:	*Casinos:*
1. Most casinos include hotels and sizable food and beverage operations, a natural synergy with HI's core expertise. **(62)**	1. Philosophical contradiction with founding principles at HI, such as family environment. **(67)**
2. Casino gaming revenue is fast growing and profitability is quite high. **(64)**	2. While HI has hospitality experience, it has little gambling experience. **(65)**
3. The demographic profile of the typical casino customer is quite similar to the typical HI hotel guest. **(table, p. 40)**	3. Gambling is only legal in a few areas. **(64)**
	4. Because of number 2 above, the cost of entry (real estate, etc. is quite high. **(64)**
	5. Compatibility with corporate image and organized crime inferences. **(67)**

Having completed a basic internal analysis for each business group, we must now look at Holiday Inns, Inc.'s strengths and weaknesses from an overall corporate level. The focus in Exhibit 5 is on the overall business portfolio and the strengths and weaknesses it provides corporate management as they view internal corporate capabilities.

These are some of the key strengths and weaknesses facing Holiday Inns, Inc. at the business and corporate level. Compared with the environment analyses in Chapters 4 and 5, this internal analysis provides the basis for generating alternative strategies. We will look at this comparison in the Chapter 7 Cohesion Case. Before leaving internal analysis, however, do you agree with the strengths and weaknesses we've identified? Are any key ones missing? Are any factors identified as strengths that could be weaknesses or vice versa?

exhibit 5
Corporate-level internal analysis

Strengths	*Weaknesses*
1. The hotel business provides an excellent cash generator to support growth areas. **(Exhibit 11)**	1. Management capability to absorb a rapidly increasing number of businesses may be severely challenged, especially in the short term.
2. Substantial and appreciating real estate holdings enhance corporate-wide debt capacity. **(Exhibit 12)**	2. Hotels and now restaurants represent a major dependence of outside franchisees—with several threatening legal challenges in progress.
3. Synergy between the hotel core and restaurant (Perkins) and casino operations should produce a distinct advantage.	3. Questionable whether some operations, especially Trailways buses, oceanic cruises, and to some extent institutional products, clearly fit with other businesses in a related diversification strategy.
4. Casino gaming and increasing resort emphasis within company-owned expansion provide a logical synergy.	4. Severity of the budget-chain threat and event price/cost squeeze to the essential cash generator—hotel group—during a time of rapid cash outflows to gain positions in other business arenas.
5. Delta Steamship provides an avenue for lessening the travel-based, cyclical exposure of other HI businesses.	5. Philosophical divisions among long-time managers over certain diversifications, especially casinos, and restaurant impact corporate-wide.
6. Restaurants, casinos, and possibly marine transport provide reasonable growth avenues as the lodging industry matures.	

exhibit 5 ***(concluded)***

Strengths	*Weaknesses*
7. Franchising and marketing expertise.	
8. The ratio cash flow/current maturities long-term debt expresses the coverage of current maturities by cash flow generated from operations. It measures the ability of a firm to service principal repayment, as well as a firm's additional debt capacity. In 1977, HI's ratio was: 52,657 + 63,034/28,707 = 4.03. This ratio implies (compared with industry averages) that HI does indeed have the capacity to assume additional debt. **(Exhibit 12)**	
9. This situation is confirmed by computing net fixed assets/tangible net worth. This ratio measures the extent to which owners' equity has been invested in plant and equipment. HI's ratio of 1.3966 compares very favorably with the industry as a whole though, providing a better cushion for creditors. **(Exhibit 12)**	
10. The debt/total capitalization ratio is now at a 10-year low for the company. In 1978, the ratio stood at 34.6 percent, down 3.1 percent from 1977 and down 32.4 percent since 1969. Return on equity has increased from 6.7 percent in 1974 to 11.9 percent in 1978. Operating income has increased 55 percent since 1974, to more than $156 million. Finally, capital expenditures reached a new high of $129 million in 1978. **(Exhibits 10, 11, 12, 13)**	

chapter 7

Formulating long-term objectives and grand strategies

IN Chapter 3 the company mission was described as encompassing the broad aims of the organization. The most specific statement of wants appeared as the goals of the firm. However, these goals, which commonly dealt with profitability, growth, and survival, were stated without specific targets or time frames. They were always to be pursued but could never be fully attained. So while they gave a general sense of direction for the firm's undertaking, goals were not intended to provide benchmarks for the evaluation of the company's progress in achieving its aims. That is the function of objectives.[1]

In the first part of this chapter, the specific focus will be on long-term objectives which are statements of the results a business seeks to achieve through its activities over a specified period of time, typically five years. In the second part of the chapter, the focus will shift to the formulation of grand strategies which provide a comprehensive general approach to guide major actions designed to accomplish major long-term objectives of a business within its dynamic environment.

The chapter has two major aims: (1) to discuss in detail the concept of long-term objectives, the topics they cover, and the qualities which they should exhibit and (2) to discuss in detail the concept of grand strategies, the 12 principal options which are available, and two approaches to grand strategy selection.

[1] Throughout this text the terms *goals* and *objectives* are each used to convey a special meaning, with *goals* being the less specific and more encompassing concept. Most writers agree with this usage of the terms. However, some authors use the two words interchangeably while others exchange the definitions for one another.

Long-term objectives

Topics covered by long-term objectives

Strategic managers recognize that short-run profit maximization is rarely the best approach to the achievement of sustained corporate growth and profitability. An often-repeated adage states that if impoverished people are given food they will enjoy eating it but will continue to be impoverished. However, if they are given seeds and tools and are shown how to grow crops, they will be able to permanently improve their condition. A parallel situation confronts strategic decision makers:

a. Should they eat the seeds by planning for large dividend payments, by selling off inventories, by cutting back on research and development to improve the near-term profit picture, or by laying off workers during periods of slack demand?

b. Or should they sow the seeds by reinvesting profits in growth opportunities, by committing existing resources in employee training in the hope of improved performance and reduced turnover, or by increasing advertising expenditures as a means to further penetrate a market?

For most strategic managers the solution is clear—enjoy a small amount of profit now in order to maintain vitality but sow the majority in order to increase the likelihood of a long-term supply. This rationale ranks as the most frequently used criterion in the selection of objectives.

To accomplish the long-term prosperity of the firm, strategic planners commonly establish long-term objectives in seven topic areas:

1. Profitability. It would be foolish to deny that the ability of any business to operate in the long run is dependent on its attaining an acceptable level of profits. Strategically managed firms characteristically have a profit objective which is usually expressed in terms of earning per share or return on equity.

2. Productivity. Strategic managers constantly try to improve the productivity of their systems. Increased profitability normally accrues to companies which can improve the input-output relationship. Thus, businesses almost always state an objective for productivity, commonly in terms of the number of items produced or the number of services rendered per unit of input. However, productivity objectives are sometimes stated in terms of desired decreases in cost—an equally effective way to increase profitability if unit output can remain relatively stable. For example, objectives may be set for reduced levels of defective items output, of customer complaints leading to litigation, or of overtime hours.

3. Competitive position. One measure of corporate success is relative dominance in the marketplace. It is common for larger firms to establish an objective in terms of competitive position as a basis for gauging their comparative ability to achieve growth and profitability. Frequently stated in

terms of total sales or market share, an objective on competitive position often serves as an indication of the relative priority of a corporation's interests in the long term. For example, in 1975 Gulf Oil set an objective of moving from third to second place as a producer of high-density polypropylene by 1981. Total sales was to be their basis of measurement.

4. *Employee development.* Employees value growth and career opportunities in an organization. When such opportunities are present, employee productivity is often increased and expensive turnover is often decreased. Therefore, strategic decision makers frequently include an employee development objective in their long-range plans. For example, PPG has declared an objective of developing highly skilled and flexible employees as a basis for providing steady employment to a reduced number of workers.

5. *Employee relations.* Companies actively seek good employee relations, whether or not they are bound by union contracts. In fact, a characteristic concern of strategic managers is for taking proactive steps in anticipation of employee needs and expectations. Strategic managers believe that employee productivity is partially tied to employee loyalty and perceived management interest in worker welfare. Therefore, strategic managers set objectives which direct resources to improve employee relations. For example, safety programs, worker representation on management committees, and employee stock option plans are all normal outgrowths of employee relations objectives.

6. *Technological leadership.* Businesses must decide whether to lead or follow in the marketplace. While either can be a successful approach, each requires a different strategic posture. Therefore, many businesses state an objective in terms of technological leadership. For example, Caterpillar Tractor Company, Inc., the manufacturer of large earth movers, established its early reputation and dominant position in its industry on its success as a forerunner in technological innovations.

7. *Public responsibility.* Businesses recognize their responsibilities to their customers and their society at large. In fact, many actively seek to exceed the minimum demands made by government. Not only do they work to develop strong reputations for fairly priced products and services, but they also attempt to establish themselves as responsible corporate citizens. For example, they may establish objectives for charitable and educational contributions, minority training, public or political activity, community welfare, and urban renewal.

Qualities of long-term objectives

What distinguishes a good objective from a bad one? What qualities should an objective exhibit in order to improve its chances of being attained?

Perhaps the best answer to these questions is found by evaluating an objective's adherence to seven criteria which should be used in the preparation of long-term objectives: acceptable, flexible, measurable over time, motivating, suitable, understandable, and achievable.

Managers are most likely to pursue objectives if they are acceptable, that is, if they are consistent with the managers' perceptions and preferences. If managers are offended by the objectives (e.g., to promote a nonnutritional food product) or believe them to be inappropriate or unfair (e.g., to reduce spoilage to offset a disproportionate fixed overhead allocation), they may ignore or even obstruct to their achievement. In addition, certain long-term corporate objectives are frequently designed to be acceptable to major interest groups which operate external to the firm. An example might involve air polution abatement efforts undertaken by the company at the insistence of the Environmental Protection Agency.

Objectives should be capable of modifications in the event of unforeseen or extraordinary changes in the firm's competitive or environmental forecasts—they should be flexible. At the same time it must be remembered that flexibility is usually increased at the expense of specificity. Likewise, employees' confidence in a subsequently developed strategy to achieve the objective may be tempered by their awareness that an adjustment in a flexible objective will probably result in a change in the part of the action plan which they have been assigned. One recommendation for providing flexibility while minimizing associated negative effects is to allow for adjustments in the level rather than nature of an objective. For example, an objective for a personnel department "to provide managerial development training for 15 supervisors per year over the next five-year period" can easily be adjusted by changing the number of people to be trained. In contrast, to change the nature of this personnel department's objective after three months to "assist production supervisors in the reducing of job-related injuries by 10 percent per year" would understandably create dissatisfaction.

Objectives must clearly and concretely state what will be achieved and within what time frame. Numerical specificity minimizes misunderstandings; thus objectives should be measurable over time. For example, an objective to "substantially improve our return on investment" would be better stated as "increase the return on investment on our line of paper products by a minimum of 1 percent a year and a total of 5 percent over the next three years."

Studies have shown that people are most productive when objectives are set at a motivating level—one which is high enough to challenge but not so high as to frustrate or so low that they are easily attained. The problem that arises is that individuals and groups differ in their perceptions of high enough. A broad objective that challenges one group frustrates another, and minimally interests a third. One valuable recommendation is to develop multiple objectives, some aimed at specific groups, rather than more sweeping statements which are usually viewed by the recipients as lacking appreciation for their individual and somewhat unique situations. Such tailor-made objectives require greater strategic decision-maker time and involvement but are also much more likely to serve as motivational forces in the organization.

Objectives must be suited to the broad aims of the organization, which are

best expressed in the statement of company mission. Each objective should be an incremental step toward the attainment of the overall goals of the firm. In fact, objectives which do not coincide with company or corporate missions can subvert the aims of the firm. For example, an objective of reducing a debt-to-equity ratio to 1.00 as a means of improving the stability of the firm would probably be unsuitable and counterproductive to the achievement of a growth-oriented mission.

Strategic managers at all levels need to have a clear understanding of what is to be achieved. They must also understand the major criteria by which their performance will be evaluated. Thus, objectives must be stated in a way such that they are as understandable to the recipient as they are to the giver. Consider the potential misunderstandings which could come from an objective "to increase the productivity of the credit card department of the bank by 20 percent within five years." Does this mean: Increase the number of cards outstanding? Increase the use of outstanding cards? Increase the department employee work load? Make productivity gains each year, or hope that the new computer-assisted system is approved by year five which should automatically improve productivity? As this simple example illustrates, objectives must be prepared in an understandable fashion which is clear, meaningful, and unambiguous.

Finally, objectives must be possible to achieve. This is easier said than done. Turbulence in the remote and task external environments adds to the dynamic nature of a business's internal operations to create an uncertain situation which limits strategic management's accuracy in setting feasible objectives. For example, the wildly fluctuating prime interest rates in 1980 made objective setting in that year extremely difficult for 1981–1985, particularly in such areas as sales projections for consumer durable goods companies like General Motors and General Electric.

Selecting among alternative grand strategies[2]

Despite variations in the implementation of the strategic management approach, there is widespread agreement among designers of planning systems on the critical role of grand strategies.[3] Intended to provide basic direction for strategic actions, grand strategies are seen as the basis of coordinated and sustained efforts directed toward the achievement of a business's long-term objectives.

As theoretically and conceptually attractive as the idea of grand strategies has proven to be, two problems have limited practicing managers' use of this approach. First, the range of alternative grand strategies available to the

[2] Portions of this chapter are adapted from John A. Pearce II, "Selecting among Alternative Grand Strategies," *California Management Review,* Spring 1982.

[3] Among recent such models or theories of strategic management are those of Pearce (1981), Steiner (1979), Higgins (1979), Ansoff (1979), King and Cleland (1978), and Steiner and Miner (1977), all listed in the bibliography to this chapter.

decision makers are often not fully understood. The tendency of strategic managers to build incrementally from the status quo often presents unnecessary limitations on their search to improve corporate performance. Other executives have simply never considered the variety of options available as attractive grand strategies. Second, strategic decision makers who generate lists of promising grand strategies are often without a logical and systematic approach to the selection of a preferable alternative. Few planning experts have attempted to proffer viable evaluative criteria and selection tools.

The purpose of this section is therefore twofold: (1) to list, describe, and discuss 12 business-level grand strategies which should be considered by strategic planners; and (2) to present approaches to the selection of an optimal grand strategy from among available alternatives.

Grand strategies

Grand strategies indicate how the business's long-range objectives will be achieved. Thus, a grand strategy can be defined as a comprehensive general approach which guides the major actions designed to accomplish long-term objectives of a business.

There are 12 principal grand strategies, any one of which could serve to provide the basis for achieving the major long-term objectives of a single business. However, when a company is involved in multiple businesses, multiple grand strategies are usually utilized in combination. Each of these grand strategies is described in this section with examples to indicate some of their relative strengths and weaknesses.

Concentration (1)

By far the most frequently selected grand strategy is *concentration* on the current business. The firm directs its resources to the profitable growth of a single product, in a single market, and with a single technology. Some of America's largest and most successful companies have traditionally adopted the concentration approach. Examples include W. K. Kellogg and Gerber Foods which are known for their product, Holiday Inn which concentrates on geographic expansion, and Lincoln Electric which bases its growth on technological advances.

The reasons for selecting a concentration grand strategy are easy to understand. Concentration is often preferred to the others because it is typically lowest in risk and in additional resources required. It is also based on the known competencies of the firm. On the negative side, for most companies a concentration strategy tends to result in steady but slow increases in growth and profitability and a more narrow range of investment options. Further, because of their narrow base of competition, concentrated firms are especially susceptable to performance variations resulting from industry trends.

The explanation as to why concentration strategies succeed for so many businesses—including the vast majority of smaller firms—can be attributed to the advantages of business-level specialization. By concentrating on one product, in one market, and with one technology, a firm can gain competitive advantages over its more diversified competitors in production skill, marketing know-how, customer sensitivity, and reputation in the marketplace.

A grand strategy of concentration allows for a considerable range of action. Broadly speaking, the business can attempt to capture a larger market share by increasing present customers' rate of usage, by attracting competitors' customers, or by interesting nonusers to buy the product or service. In turn, each of these actions suggests a more specific set of alternatives. Some of these options are listed in the top section of Figure 7-1.

Market development (2) and product development (3)

When strategic managers forecast that the combination of their current products with their markets will not provide a basis from which they can achieve their company mission, they have two options which are moderate in cost and risk—market development and product development.

Market development commonly ranks second only to concentration as the least costly and least risky of the 12 grand strategies. It consists of marketing present products, often with only cosmetic modifications, to customers in related market areas by adding different channels of distribution or by changing the content of its advertising or its promotional media. Several specific approaches are listed under this heading in Figure 7-1. Thus, as suggested by the figure, businesses which open branch offices in new cities, states, or countries are practicing market development. Likewise, companies which switch from advertising in trade publications to newspapers or which add jobbers to supplement their mail-order sales efforts are using a market development approach.

Product development involves substantial modification to existing products or the creation of new but related items which can be marketed to current customers through established channels. The adoption of the product development strategy is often made either to prolong the life cycle of current products or to take advantage of favorable reputation and brand name. The idea is to attract satisfied customers to try new products as a result of their positive experience with the company's initial product offering. The bottom section of Figure 7-1 lists some of the many specific options available to businesses which undertake product development. Thus, a revised edition of a college textbook, a new car style, and a second formula of shampoo for oily hair each represents a business-level product development strategy.

Strategy in Action 7-1 shows how Stanley Works was able to combine market and product development into an extremely effective grand strategy.

figure 7-1
Specific options under the grand strategies of concentration, market development, and product development

Grand Strategy: Concentration (increasing use of present projects in present markets):

1. Increasing present customers' rate of usage.
   a. Increasing the unit of purchase size.
   b. Increasing the rate of product obsolescence.
   c. Advertising other uses.
   d. Giving price incentives for increased use.
2. Attracting competitors' customers.
   a. Establishing sharper brand differentiation.
   b. Increasing promotional effort.
   c. Initiate price cuts.
3. Attracting nonusers to buy the product.
   a. Inducing trial use through sampling, price inducements, and so on.
   b. Pricing up or down.
   c. Advertising new uses.

Grand Strategy: Market development (selling present products in new markets):

1. Opening additional geographical markets.
   a. Regional expansion.
   b. National expansion.
   c. International expansion.
2. Attracting other market segments.
   a. Developing product versions to appeal to other segments.
   b. Entering other channels of distribution.
   c. Advertising in other media.

Grand Strategy: Product development (developing new products for present markets):

1. Developing new product features.
   a. Adapt (to other ideas, developments).
   b. Modify (change color, motion, sound, odor, form, shape).
   c. Magnify (stronger, longer, thicker, extra value).
   d. Minify (smaller, shorter, lighter).
   e. Substitute (other ingredients, process, power).
   f. Rearrange (other patterns, layout, sequence, components).
   g. Reverse (inside out).
   h. Combine (blend, alloy, assortment, ensemble; combine units, purposes, appeals, ideas).
2. Developing quality variations.
3. Developing additional models and sizes (product proliferation).

* Adapted from H. Igor Ansoff, "Strategies for Diversification," *Harvard Business Review*, September-October 1957; David J. Luck and Arthur E. Prell, *Market Strategy* (New York: Appleton-Century-Crofts, 1968), pp. 175–83; Alex F. Osborn, *Applied Imagination*, 3d rev. ed. (New York: Charles Scribner's Sons, 1963), pp. 286–87; Arthur A. Thompson and A. J. Strickland, *Strategy Formulation and Implementation* (Plano, Tex.: Business Publications, 1980), p. 104; and Philip Kotler, *Marketing Management: Analysis, Planning, and Control*, 2d ed., © 1972, pp. 170, 237. Reprinted by permission of Prentice-Hall, Inc., Englewood Cliffs, N.J.

strategy in action, 7-1

Stanley Works

Spurred by inflation in the early 1970s, homeowners increasingly picked up hammers, saws, screwdrivers, and the like and started doing their own remodeling and repairs. Stanley Works viewed the do-it-yourself market as the budding of a permanent phenomenon, and the do-it-yourself market became the focus of the diversified toolmaker's corporate strategy. Principally because of that decision the New Britain (Connecticut) Company was riding atop the rapidly expanding $22 billion do-it-yourself market by early 1979.

In a period when many companies were preparing for an economic dip, Stanley's grip on consumer hand tools was enviable, since the do-it-yourself business is usually countercyclical. Stanley's strategic move toward this market was made more impressive because it had prompted a radical transformation of the company. By 1979, Stanley, the nation's leading producer of hand tools, garnered roughly 80 percent of its business from sales to do-it-yourselfers. In the early 1970s, by contrast, sales to amateur remodelers accounted for just above 30 percent.

A number of changes in product lines, operations, and marketing went into the shift. The company redesigned many of its hammers, tape rules, and other tools as less expensive offerings for amateurs, rather than for professionals. Stanley also launched a costly television and print advertising campaign, designed both to promote its tools and to draft new volunteers into the do-it-yourself army.

Stanley's emphasis on the do-it-yourself market paid off. In 1978, the company's earnings rose a record $42 million, on an 18 percent sales increase, to $755 million. Still, Stanley estimated that it would grow more than 15 percent annually over 1979–83. Stanley also planned to develop foreign markets—especially in Western Europe. Their strategic managers predicted that by 1984 the European market would be well developed. Thus they intended to have a complete offering of products throughout Europe by that time.

Source: Based on the article "Stanley Works: Capitalizing on the Homeowner Do-It-Yourself Trend," from the February 26, 1979 issue of *Business Week*.

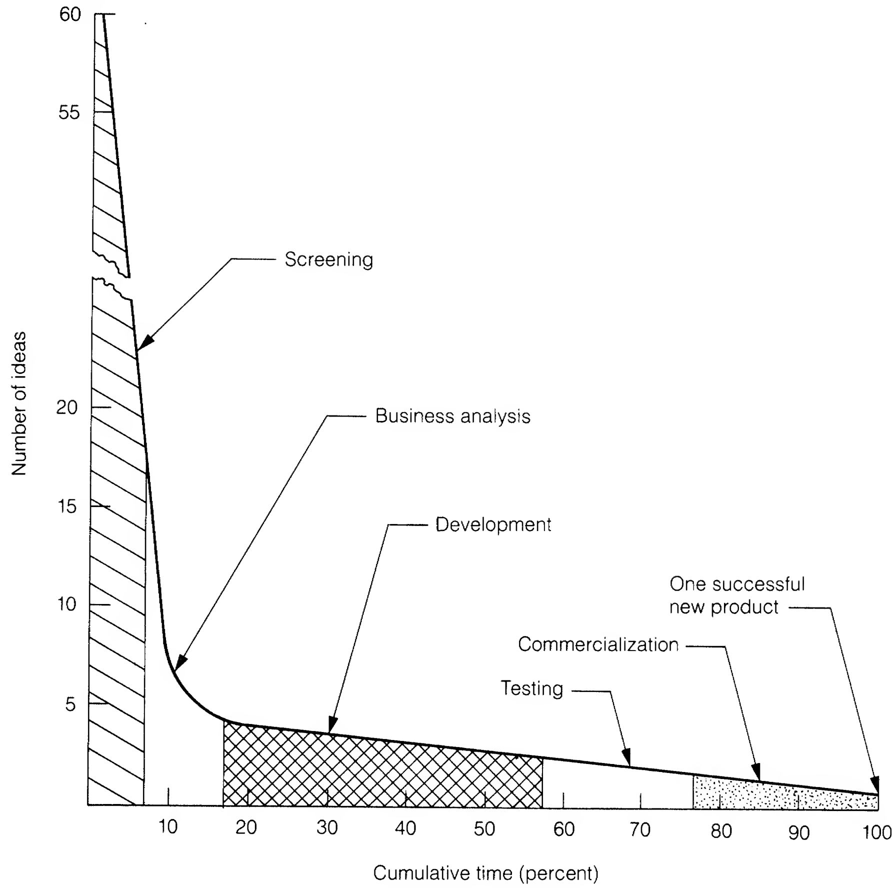
Innovation (4)

It is increasingly risky in many industries not to innovate. Consumer as well as industrial markets have come to expect periodic changes and improvements in the products which are offered. As a result, some businesses find it profitable to base their grand strategy on *innovation*. They seek to reap the initially high profits associated with customers' acceptance of a new or greatly improved product. Then, rather than face stiffening competition, as the basis of profitability shifts from innovation to production or marketing competence, they move on to search for other original or novel ideas. The underlying philosophy of a grand strategy of innovation is to create a new product life cycle, thereby making any similar existing products obsolete. Thus, this approach differs from product development wherein the strategy is to find a means of extending an existing product life cycle. The automobile industry provides many excellent examples. Ford Motor Company's 1981 introduction of the sporty, economical two-seat EXP was an effort to interest a segment of American drivers who traditionally bought foreign-made sports cars to try a Ford product. This represented an innovation strategy because a new life cycle had been started for Ford. At the same time Ford made modifications to the Fairmont model which made it lighter in weight and more fuel efficient. This represented a product development strategy since the Fairmont life cycle had been extended.

While most growth-oriented firms appreciate the need to be occasionally innovative, a few companies use it as their fundamental way of relating to their markets. An outstanding example is Polaroid which heavily promotes each of its new cameras until competitors are able to match their technological innovation. At that time Polaroid is normally prepared to introduce a dramatically new or improved product. For example, in short succession consumers were introduced to the Swinger, the SX-70, the One Step, and the Sun Camera 660.

Few innovative ideas prove to be profitable. The reason stems from the extremely high research, development, and premarketing costs incurred in converting a promising idea into a profitable product. A study by the management research department of Booz, Allen and Hamilton provides some understanding of the risks. As shown in Figure 7–2, they studied 51 companies and found that less than 2 percent of the innovative projects which they initially considered eventually reached the marketplace. Specifically, out of every 58 new product ideas only 12 pass an initial screening test which finds them to be compatible with the company's mission and long-term objectives. Only seven of these remain after an evaluation of their profit potential and only three survive actual attempts to develop the product. Two of these still appear to have profit potential after test marketing but, on the average, only one will be commercially successful. In fact, other studies believe this success rate to be overly optimistic. For example, the results of

figure 7-2
Decay curve of new product ideas (51 companies)



one research project disclosed failure rates for commercialized products to be as high as 89 percent.[4]

Horizontal integration (5) and vertical integration (6)

When the long-term strategy of a firm is based on growth through the acquisition of one or more businesses operating at the same stage of the production-marketing chain, its grand strategy is called *horizontal integration.* Such acquisitions not only provide access to new markets for the acquiring firm but also result in the elimination of competitors from the

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[4] Burt Schorr, "Many New Products Fizzle, Despite Careful Planning, Publicity," *The Wall Street Journal,* April 5, 1961.

marketplace. For example, Warner-Lambert Pharmaceutical Company's acquisition of Parke Davis in 1970 reduced competition in the ethic drugs field for Chilcott Laboratories, a company which Warner-Lambert had previously acquired. It therefore constituted a horizontal integration. A second example is seen in the long-range acquisition pattern of White Consolidated Industries, which accomplished its growth in the market of refrigerators and freezers through a grand strategy of horizontal integration. In 1967 it acquired the Franklin Appliance Division of Studebaker, in 1978 it bought the Kelvinator Appliance Division of American Motors, in 1971 it acquired Refrigerator Products Division of Bendix Westinghouse Automotive Air Brake, and finally in 1979 it bought Frigidaire Appliance from General Motors. For yet another example of a successful horizontal integration grand strategy read the case of LTV in Strategy in Action 7–2. Thus, the combinations of

strategy in action, 7–2

LTV

Since 1971, Dallas-based LTV Corp. has been cautiously avoiding exposure to risk, inching its way out of a huge debt amassed in the 1960s. However, prodded by the senior staff of LTV's troubled steel subsidiary Jones and Laughlin Steel Corporation, LTV took its greatest risk of all in merging with ailing Lykes Corporation, which had an equally troubled steel subsidiary, Youngstown Sheet and Tube Company.

The grand strategy was to make one strong suit of the two weakest companies in the battered steel industry by eliminating duplication, waste, and inefficiency. For this strategy to work, a number of elements had to fall into line. LTV could achieve efficiencies by dovetailing the two companies' supplies of raw materials, combining marketing efforts, and trimming transportation costs and overhead. But these benefits had to outweigh a variety of difficulties, including sluggish markets, competitive imports, and steel plants located in saturated market areas. In addition, both companies were heavily leveraged. LTV owed $1 billion, while its net worth was only $402 million. Lyke's long-term debt was $693 million versus $542 million in net assets. Both companies had huge unfunded pension liabilities, and both had cash flow problems in the face of capital requirements.

Nevertheless, Lykes and LTV officials were confident that the two companies operating together could be, if not immediately profitable outright, at least less unprofitable.

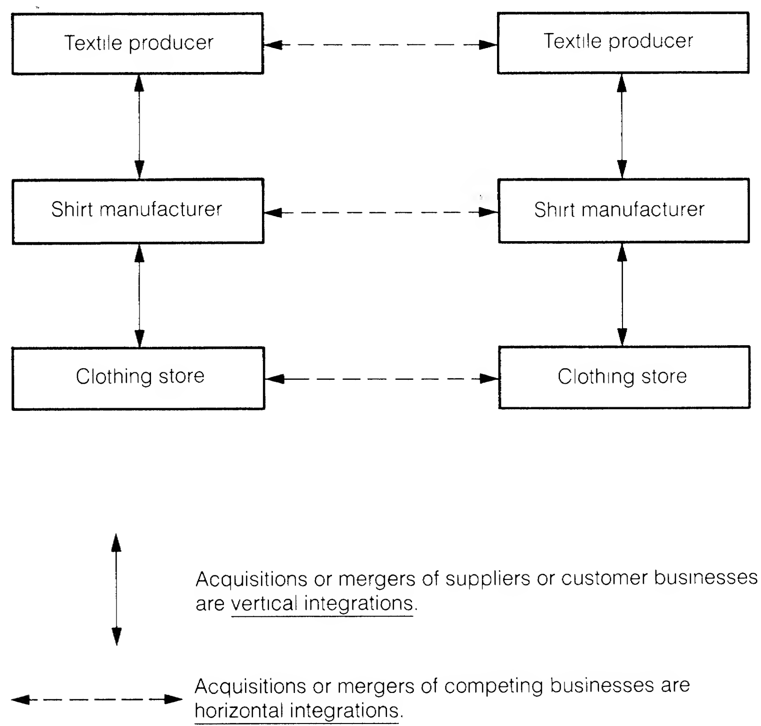
Source: Based on the article "LTV's Play to Cut Its Losses through a Merger with Lykes," from the January 9, 1978 issue of *Business Week*.

two textile producers, two shirt manufacturers, or two clothing store chains would be classified as horizontal integrations.

When the grand strategy of a firm involves the acquisition of businesses which either supply the firm with inputs such as raw materials, or which serve as a customer for the firm's outputs such as warehousers for finished products, it is engaged in *vertical integration*. For example, if a shirt manufacturer acquires a textile producer—by purchasing its common stock, buying its assets, or through an exchange of ownership interests—the strategy is a vertical integration. In this case it is a *backward* vertical integration since the acquisition is of a business operating at an earlier stage of the production/marketing process. If the shirt manufacturer had merged with a clothing store, it would have been an example of *forward* vertical integration since it involved the acquisition of a business nearer to the ultimate consumer at the final stage of the production/marketing process.

Figure 7-3 depicts both horizontal and vertical integrations using the examples just discussed. The principal attractions of a horizontal integration grand strategy are readily apparent. The acquiring firm is able to greatly expand its operations thereby achieving greater market share, improving economies of scale, and increasing efficiency of capital usage. Additionally,

figure 7-3
Vertical and horizontal integrations



these benefits are achieved with only a moderate level of increased risk to the firm, since the success of the expansion is principally dependent upon proven abilities of the company.

The reasons behind the choice of a vertical integration grand strategy are more varied and sometimes less obvious. The main reason for backward integration is the desire to increase the dependability of the supply or quality of raw materials or production inputs. The concern is particularly great when the number of suppliers is few and the number of competitors is many. In this situation, the vertically integrating firm can better control its costs and thereby improve the profit margin of the expanded production/marketing system. Forward integration is a preferred grand strategy for firms when the advantages of stable production are particularly high. A business can increase the predictability of the demand for its output through forward integration, that is, through ownership of the next stage of its production/marketing chain.

There are also some increased risks associated with both types of integration grand strategies. For horizontally integrated firms the risks stem from the increased commitment of the company to one type of business. For vertically integrated firms the risks result from expansion of the company into areas which require strategic managers of the original business to broaden the base of their competences and to assume additional responsibilities.

Joint venture (7)

Occasionally two or more capable companies lack a necessary component for success in a particular competitive environment. For example, no single petroleum firm controlled sufficient resources to enable it to construct the Alaskan pipeline. Nor was any single firm capable of processing and marketing the volume of oil which would flow through the pipeline if it could be constructed. The solution was a set of joint ventures. As shown in Figure 7–4, these cooperative arrangements could provide both the necessary funds to build the pipeline and the processing and marketing capacity to profitably handle the oil flow.

The particular form of joint venture discussed above is called joint ownership.[5] In recent years it has become increasingly appealing for domestic firms to join with foreign businesses through the use of this form. For example, Bethlehem Steel acquired an interest in a Brazilian mining venture as a means of securing a raw material source. The stimulus for this joint ownership venture was preference in grand strategy, but such is not always the case. Certain countries virtually mandate that foreign companies entering their markets do so on a joint-ownership basis. India and Mexico are good

[5] Other forms of joint ventures such as leasing, contract manufacturing, and management contracting offer valuable support strategies. However, because they are seldom employed as grand strategies, they are not included in the categorization.

figure 7-4
Typical joint ventures in the oil pipeline industry

Pipeline company (assets in $ millions)	*Co-owners*	*Percent held by each*
Colonial Pipeline Co. ($480.2)	Amoco	14.3
	Atlantic Richfield	1.6
	Cities Service	14.0
	Continental	7.5
	Phillips	7.1
	Texaco	14.3
	Gulf	16.8
	Sohio	9.0
	Mobil	11.5
	Union Oil	4.0
Olympic Pipeline Co. ($30.7)	Shell	43.5
	Mobil	29.5
	Texaco	27.0
West Texas Gulf Pipeline Co. ($19.8)	Gulf	57.7
	Cities Service	11.4
	Sun	12.6
	Union Oil	9.0
	Sohio	9.2
Texas-New Mexico Pipeline Co. ($30.5)	Texaco	45.0
	Atlantic Richfield	35.0
	Cities Service	10.0
	Getty	10.0

Source: Testimony of Walter Adams in *Horizontal Integration of the Energy Industry,* hearings before the Subcommittee on Energy of the Joint Economic Committee, 94th Congress, 1st sess. (1975), p. 112.

examples. The rationale of these foreign countries is that such joint ventures minimize the threats of foreign domination and enhance the skills, employment, growth, and profits of local businesses.

One final note: Strategic managers in the typical firm rarely seek joint ventures. This approach admittedly presents new opportunities with risks that can be shared. On the other hand, joint ventures often limit partner discretion, control, and profit potential while demanding managerial attention and other resources which might otherwise be directed toward the mainstream activities of the firm. Nevertheless, increasing nationalism in many foreign markets may require greater consideration of the joint venture approach if a firm intends to diversify internationally.

Concentric diversification (8) and conglomerate diversification (9)

Grand strategies involving diversification represent distinctive departures for a firm's existing base of operations. They typically involve the acquisition or internal generation (spin-off) of a separate business which offers synergistic possibilities because of the counterbalancing possibilities of the two businesses' strengths and weaknesses. For example, Head Ski initially

sought diversifications into summer sporting goods and clothing in order to offset the seasonality of its snow skiing equipment business. However, diversifications are occasionally undertaken as unrelated investments because of their otherwise minimal resource demands and high-profit potential.

Regardless of the approach that is taken to diversification—concentric or conglomerate diversifications—the motivations of the acquiring firms stem from the same basic set of needs. As summarized by Glueck these motives include the following:

To increase the firm's stock value. Often in the past, mergers have led to increases in the stock price and/or price-earnings ratio.

To increase the growth rate of the firm faster than present internal growth strategy.

To make a good investment to purchase a unit which makes a better use of funds than plowing the same funds into internal growth.

To improve the stability of a firm's earnings and sales. This is done by acquiring firms whose earnings and sales complement the firm's peaks and valleys.

To balance of fill out the product line.

To diversify the product line when the life cycle of current products has peaked.

To acquire a needed resource quickly; for example, high-quality technology or highly innovative management.

For tax reasons: to purchase a firm with prior tax losses which will offset current or future earnings.

To increase efficiency and profitability, especially if there is synergy between the two companies.[6]

When a diversification involves the addition of a business whose activities are related to the firm's current offerings in terms of technology, markets, or products, it is a *concentric diversification*. With this type of grand strategy the strategic decision makers of the acquiring firm make a conscious effort to select new businesses which possess a high degree of compatability with their current businesses. The ideal concentric diversification occurs when the combination of company profiles results in increased strengths and opportunities, as well as decreased weaknesses and exposure to risk. Thus, the acquiring company searches for new businesses whose products, markets, distribution channels, technologies, and resource requirements are familiar but not identical, synergistic but not wholly interdependent. Examples are plentiful: Eastman Kodak, Procter & Gamble, Johnson & Johnson, United States Steel, and dozens of others.

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[6] William F. Glueck, *Business Policy and Strategic Management* (New York: McGraw-Hill, 1980), p. 213.

Occasionally a firm, particularly a very large one, plans to acquire a business because it represents the most promising investment opportunity available. This type of grand strategy is commonly known as *conglomerate diversification*. The principal and often sole concern of the acquiring firm is for the profitability of the venture. There is little concern given to creating product/market synergy with existing businesses of the firm, contrary to the approach taken in concentric diversification. However, financial synergy is often sought by conglomerate diversifiers such as ITT, Textron, American Brands, Litton, U.S. Industries, Fuqua, and I.C. Industries. For example, they may seek a balance in their portfolios between current businesses with cyclical sales and acquired businesses with countercyclical sales, between high-cash/low-opportunity and low-cash/high-opportunity businesses, or between debt-free and highly leverage businesses.

The principal difference between the two types of diversification is that concentric acquisitions emphasize some commonality in markets, products, or technology whereas conglomerate acquisitions are based principally on profit considerations.

Retrenchment/turnaround (10)

For any of a large number of reasons a business can find itself in a period of declining profits. Economics recessions, production inefficiencies, and innovative breakthroughs by competitors are only three examples. In many such cases strategic managers believe that the firm can survive and eventually recover prosperously if a concerted effort is made over the period of a few years to fortify the basic distinctive competencies of the business. This type of grand strategy is known as *retrenchment*. It is typically accomplished through one of two ways, employed singly or in combination:

1. Cost reduction. Examples include decreasing the size of the work force by not replacing employees lost through attrition, leasing rather than purchasing equipment, extending the life of machinery, and eliminating elaborate promotional activities.
2. Asset reduction. Examples include the sale of land, buildings, and equipment which are nonessential to the basic activity of the business; and the elimination of the company airplane and executive cars as prerequisites.

If these initial approaches fail to achieve the required reductions, more drastic action may be necessary. It is sometimes essential to lay off employees, drop items from a production line, and even to eliminate low-margin customers.

Since the underlying purpose of a grand strategy of retrenchment is to reverse current negative trends, the method is often referred to as a *turnaround* strategy. Interestingly, the turnaround most commonly associated with this approach is in management positions. In a study of 58 large firms,

researchers Schendel, Patton, and Riggs found that retrenchment for turnaround was almost always associated with changes in top management.[7] Bringing in new managers was believed to introduce needed new perspectives on the firm's situation, to raise employee morale, and to facilitate drastic actions such as deep budgetary cuts in established programs.

Divestiture (11)

A *divestiture strategy* is the marketing for sale of a business or a major component of a business. When a retrenchment strategy fails to accomplish the desired turnaround, strategic managers often decide to sell the business. However, because the intent is to find a buyer who is willing to pay a premium above the value of fixed assets for a going concern, the term *marketing for sale* is more appropriate. Prospective buyers must be convinced that because of their skills and resources, or the synergy which can be created between their existing businesses and this new addition, they will be able to profit from the acquistion.

The reasons for divestitures vary. Often they arise because of partial mismatches between the acquired business and the parent corporation. In time, some of the mismatched parts cannot be integrated into any of the corporation's mainstreams and thus must be spun off. A second reason for divestiture is the financial needs of the corporation. Sometimes the cash flow or financial stability of the corporation as a whole can be greatly improved if businesses with high-market value can be sacrificed. A third, less frequent, reason for divestiture is government antitrust action which is invoked whenever a corporation is believed to monopolize or unfairly dominate a particular market.

Although examples of grand strategies of divestiture are numerous, an outstanding example in the last decade is Chrysler Corporation, which in quick succession divested itself of several major businesses in order to protect its mission as a domestic automobile manufacturer. Among major Chrysler sales were its Airtempt air-conditioning business to Fedders and its automotive subsidiaries in France, Spain, and England to Peugeot-Citroen. These divestitures yielded Chrysler a total of almost $500 million in cash, notes, and stock, and thus, in the relatively short term, improved its financial stability. Other corporations which have recently pursued this type of grand strategy include Esmark, which divested Swift and Company, and White Motors, which divested White Farm.

An example of the value of divestiture is shown in Strategy in Action 7–3. As is discussed, Dean Foods used the proceeds of divestitures together with savings from selective retrenchments to pursue new products and market development.

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[7] Dan Schendel, G. Richard Patton, and James Riggs, "Corporate Turnaround Strategies: A Study of Profit Decline and Recovery," *Journal of General Management* 3 (1976): 3–11.

strategy in action, 7-3
Dean Foods

For scores of regional dairies, the milk market had soured. In the late 1970s, diet conscious and aging consumers had shunned high-fat dairy products in favor of low-calorie foods, and competition for the business that remained was increasingly fierce. But while many milk processors were looking to sell out, Chicago-based Dean Foods Company, a $347 million dairy concern, was doing so well that it feared that it might be acquired.

In the early 1970s, Dean's executives pushed through a far-reaching program to upgrade equipment and cut costs. The company was using the higher profits that resulted from those moves to diversify into other refrigerated foods, such as party dips and a cranberry drink, which were faster-growing, higher-margin operations than the company's traditional dairy business. Dean's strategic managers were succeeding in using newer products to recapture sales that milk-based products were losing.

Dean's diversification proved to be successful. During 1974–1977, earnings rose at a compound annual rate of 42 percent, to a $7.4 million in 1977 on sales of $347 million. The money for the diversification program came largely from Dean's early cost-cutting campaign. Several unprofitable businesses were sold; Dean then invested heavily in more efficient, high-speed milk-processing equipment.

It may be that Dean's growth potential had only begun to be topped. Because of shelf-life limitations and high transportation costs, the dairy business was quite localized, making it possible for an aggressive marketer like Dean to compete successfully with the large food processors.

Source: Based on the article "Dean Foods: Diversifying to Supplement a Low-growth Business," from the December 18, 1978 issue of *Business Week*.

Liquidation (12)

When the grand strategy is that of *liquidation,* the business is typically sold in parts, only occasionally as a whole, but only for its tangible asset value and not as a going concern. In selecting liquidation, owners and strategic managers of a business are admitting failure and recognize that this action is likely to result in great hardships to themselves and their employees. For these reasons liquidation is usually seen as the least attractive of all grand strategies. However, they chose it as a long-term strategy in order to minimize the loss of all stakeholders of the firm. Usually faced with bankruptcy, the liquidating business tries to develop a planned and orderly sys-

tem which will result in the greatest possible profit and cash conversion as the business slowly relinquishes its market share.

Planned liquidation can be worthwhile. For example, the Columbia Corporation, a $130 million diversified firm, liquidated its assets for more cash per share than the market value of its stock.

Selection of long-term objectives and grand strategy sets

At first glance the strategic management model, which provides the framework for study throughout this book, appears to indicate that strategic choice decision making leads to the sequential selections of long-term objectives and grand strategy. In fact, however, strategic choice is the selection of long-range objectives and grand strategy. Figure 7–5, which first appeared as Figure 2–2, presents a depiction of the actual process. When strategic planners study their interactive opportunities, they try to determine which ones are most likely to result in achievement of various long-range objectives. Almost simultaneously they attempt to forecast the probable success of available grand strategy in taking advantage of preferred interactive opportunities so that the tentatively selected objectives can be met. In essence then, three distinct but highly interdependent choices are being made at one time. Usually several of these trials or sets of possible decisions are considered and each is measured against multiple selection.

A simplified example of this process is shown in Figure 7–6. In this example the business has determined that six strategic choice options are available. These options stem from three different interactive opportunities, e.g., West Coast markets which present little competition. Because each of these interactive opportunities can be approached through different grand strategies—in options 1 and 2 they are horizontal integration and market development—each offers the potential for achieving long-range objectives to varying degrees. Thus, a business can rarely determine its strategic choice simply on the basis of its preferred interactive opportunity, long-range objectives, or grand strategy. Instead, all three elements must be considered simultaneously.

In an actual decision situation the strategic choice would be complicated by a wider variety of interactive opportunities, feasible company objectives, promising grand strategy options, and evaluative criteria. Nevertheless, Figure 7–6 does partially reflect the nature and complexity of the process by which a final selection of long-term objectives and grand strategy are determined.

In the next chapter, the process of strategic choice will be fully explained. Knowledge of long-term objectives and grand strategies is an essential input to an understanding of that decision process. Thus, the topics were presented here first even though a company's specific selections of long-term objectives and grand strategies are actually outputs from strategic choice as shown accurately in the strategic management process model.

figure 7-5
Detailed component: Interactive opportunities analysis and strategic choice

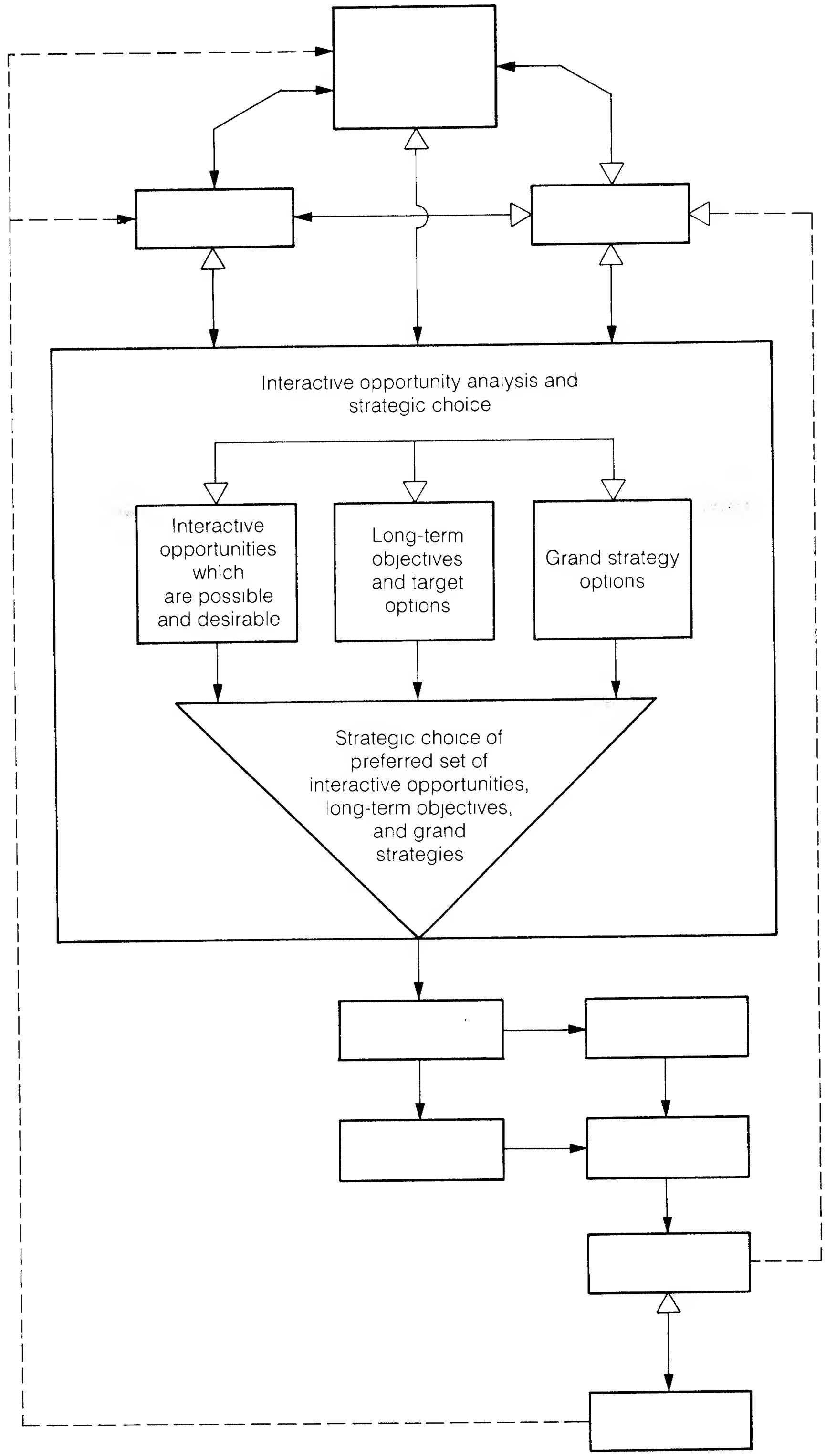


figure 7–6
A profile of strategic choice options

	Strategic choice options					
	1	*2*	*3*	*4*	*5*	*6*
Interactive opportunities	*West Coast markets present little competition*		*Current markets sensitive to price competition*		*Current industry product lines offer too narrow a range or markets*	
Appropriate long-range objectives (limited sample) Average 5-year ROI Company sales by year 5 Risk of negative profit	15% +50% .30	19% +40% .25	13% +20% .10	17% +0% .15	23% +35% .20	15% +25% .05
Grand strategies	Horizontal integration	Market development	Concentration	Selective retrenchment	Product development	Concentration

Sequence of objectives and strategy selection

The selection of long-term objectives and grand strategies by a strategic management team involves simultaneous rather than sequential decisions. While it is true that objectives are needed so that the company's direction and progress are not determined by random forces, it is equally true that objectives are valuable only if strategies can be implemented, making achievement of objectives a realistic possibility. In fact, the selection of long-term objectives and grand strategies is so interdependent that until the 1970s most business consultants and academicians did not stress the need to distinguish between them. Most popular business literature and practicing executives still combine long-term objectives and grand strategies under the heading of the company strategy.

However, the distinction has merit. Objectives indicate what strategic managers *want* but provide few insights as to *how* they will be achieved. Conversely, strategies indicate what type of *actions* will be taken but do not define what *ends* will be pursued or what criteria will serve as constraints in refining the strategic plan.

This latter notion of viewing objectives as constraints on strategy formulation rather than as ends toward which strategies are directed is stressed by several prominent management experts.[8] They argue that strategic decisions are designed (1) to satisfy the minimum requirements of different company groups, e.g., the production department's need for more inventory capacity, or the marketing department's need to increase the sales force size, and (2) to create synergistic profit potential given these constraints.

Does it matter whether strategic decisions are made to achieve objectives or to satisfy constraints? No it does not, because constraints are objectives themselves. The constraints of needing increased inventory capacity is an objective not a certainty. Likewise, the constraint of needing a larger sales force does not assure that it will be achieved given such factors as other company priorities, labor market conditions, and the firm's profit performance.

Grand strategy selection at the business level

What factors should a single business consider in selecting its grand strategy? What is the relative attractiveness of each of the 12 grand strategy options for a single business? Two approaches to answering these questions are the focus of this section. Then, in the next chapter, techniques will be discussed which show how business-level grand strategies can be combined

[8] See, for example, P. F. Drucker, *The Practice of Management* (New York: Harper & Row, 1954); R. M. Cyert, and J. G. March, *A Behavioral Theory of the Firm* (Englewood Cliffs, N.J.: Prentice-Hall, 1963); H. A. Simon, "On the Concept of Organizational Goals," *Administrative Science Quarterly* 9 1964): 1–22; and M. D. Richards, *Organizational Goal Structures* (St. Paul: West Publishing, 1978).

synergistically to provide the foundation for multibusiness/corporate-level grand strategies.

Grand strategy selection matrix

One valuable guide to the selection of a promising business-level grand strategy is the matrix shown in Figure 7–7. The basic idea underlying the matrix is that two variables are of central concern in the selection process: the principal *purpose* of the grand strategy and the choice of an internal or external *emphasis* for growth and profitability.

Although a company profile usually reveals areas of both strength and weakness in a business, strategic managers attempt to gain some feel for the basis on which they should develop their grand strategy. In the 1950s and 1960s it was fashionable to advise planners to follow certain rules or prescriptions concerning their choice of strategies. Most experts now agree that strategy selection is much better guided by the unique set of conditions

figure 7–7
Grand strategy selection matrix

Principal purpose of the grand strategy	*Areas of emphasis*	
	Internal (redirected resources within the firm)	*External (acquisition or merger for resource capability)*
Overcome weaknesses	Quadrant II Turnaround or retrenchment Divestiture Liquidation	Quadrant I Vertical integration Conglomerate diversification
Maximize strengths	Quadrant III Concentration Market development Product development Innovation	Quadrant IV Horizontal integration Concentric diversification Joint venture

which are seen to exist for the planning period and the company strengths and weaknesses. What is valuable to note, however, is that even early approaches to selecting a good strategy were based on matching a concern for internal versus external growth with a principal desire either to overcome weakness or to maximize strength.

The same two concerns led to the development of the grand strategy selection matrix. A firm in Quadrant I often views itself as overly committed to a particular business which has limited growth opportunities or which involves high risks due to the problems of having all of the company's "eggs in one basket." One reasonable solution is *vertical integration,* which enables the firm to reduce risk by reducing uncertainty either about inputs or about access to customers. Alternatively, a firm may choose *conglomerate diversification,* which provides a profitable alternative for investment without diluting the attention which management can give to the original business. However, the external orientation for overcoming weaknesses usually results in the most costly grand strategies. The decision to acquire a second business demands both large initial time investments and sizable financial resources. Thus, strategic managers who are considering these approaches must be cautious not to exchange one set of weaknesses for another.

A more conservative approach to overcoming weakness is found in quadrant II. Firms often choose to redirect resources within the company from one business activity to another. While this approach does not reduce the company's commitment to its basic mission, it does reward success and enable the further development of proven competitive advantages. The least disruptive of the quadrant II strategies is *retrenchment,* which results in the pruning of a current business's activities. In situations where the weaknesses arose from inefficiencies such retrenchment can actually serve as a *turnaround* strategy, meaning that the business gains new strength through a streamlining of its operations coupled with an elimination of waste. However, when the weaknesses of the firm constitute a major obstruction to success in the industry, and when the costs of overcoming the weaknesses cannot be afforded or are not justified by a cost-benefit analysis, then the elimination of the business must be considered. *Divestiture* offers the best possibility for recouping the company's investment, but even *liquidation* can be an attractive option when the alternatives are an unwarranted drain on organizational resources or bankruptcy.

A commonly repeated business adage argues that a company should build from strength. The premise is that a company's growth and survival depend on its ability to capture a sufficient market share to enable essential economies of scale. For firms that also believe that their profitability will derive from this approach and which prefer an internal emphasis for maximizing their strengths, four alternative grand strategies hold considerable promise. As shown in quadrant III, the most frequently adopted approach is *concentration* on the business, i.e., market penetration. The business which selects this strategy is strongly committed to its present products

and markets. It will strive to solidify its current position by reinvesting resources in a fortification of its strength.

Two alternative approaches are *market* and *product development*. With either of these strategies the business attempts to broaden the basis of its operations. Market development is chosen when strategic managers feel that the existing product offering would be well received by new customer groups. Product development is preferred when existing customers are believed to have interest in products related to the firm's current lines or based on its special technological or other competitive advantages. A final alternative for quadrant II firms is an *innovation* strategy. When the business's strengths are in creative product design or unique production technologies, it is often strategically attractive to stimulate consumer purchases by accelerating perceived obsolescence. This is the principal view underlying the selection of an innovative grand strategy.

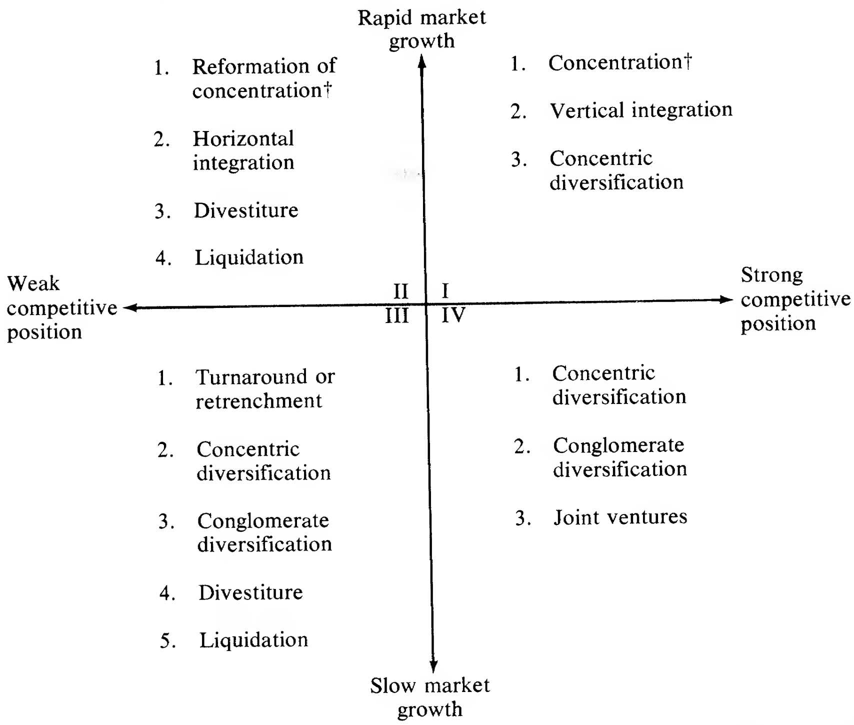
When a business seeks to maximize its strength by aggressively expanding the basis of its operations, then an external emphasis is usually required in the selection of its grand strategy. Its preferred options are shown in quadrant IV. *Horizontal integration* is attractive because it enables firms to quickly multiply the output capability of the business. The proven skills of the original business's managers are often the critical dimension in converting the new facilities into a profitable contributor to the parent company, thus expanding a fundamental competitive advantage of the firm. *Concentric diversification* is a good second choice for similar reasons. Because of the relatedness of the original and newly acquired businesses, the distinctive competencies of the firm are likely to facilitate a smooth, synergistic, and profitable expansion of the company's operations. The final option for increasing resource capability through external emphasis is through *joint venture*. This alternative allows the business to extend its strengths into competitive arenas which for one of various reasons it would be hesitant to attempt single-handedly. However, because of the partner's production, technological, financial, or marketing capabilities, a joint venture can significantly reduce financial investment and increase the probability of success to the point that formidable ventures become attractive growth alternatives.

Model of grand strategy clusters

A second guide to the selection of a promising business-level grand strategy was suggested by the business portfolio matrix of the Boston Consulting Group and was further detailed by Thompson and Strickland (1980).[9] As shown in Figure 7–8, a business's situation is defined in terms of the growth rate of the general market and in terms of the company's competitive position in that market. When these two factors are considered simultaneously, a business can be broadly categorized into one of four quadrants: (I) strong

[9] The business portfolio matrix will be fully discussed in Chapter 8.

figure 7-8
Model of grand strategy clusters*



Note: The grand strategy of innovation was omitted from this model. Apparently the authors felt that the notion of market growth was incompatible with the arguments underlying the innovation approach.

* Grand strategies listed in probable order of attractiveness.

† In this model the grand strategy of concentration was meant to encompass the grand strategies of market development and product development.

Source: Adapted from Arthur A. Thompson, Jr., and A. J. Strickland III, *Strategy and Policy Concepts and Cases* (Plano, Tex.: Business Publications, 1980), p. 132.

competitive position in a rapidly growing market, (II) weak position in a rapidly growing market, (III) weak position in a slow-growth market, or (IV) strong position in a slow-growth market. Each of these four quadrants suggests a set of promising possibilities for the business in its selection of a grand strategy.

Firms in quadrant I are in an excellent strategic position. One obvious grand strategy for such firms is continued concentration on their current business as it is presently defined. Because consumers seem well satisfied with the firm's current strategy, it would be dangerous to shift notably from its established competitive advantages. However, if the resources of the business exceed the demands of a concentration strategy, the firm should consider vertical integration. By integrating either forward or backward a

business can help to protect its profit margins and market share since either access to consumers or to material inputs are better ensured. Finally, a quadrant I firm might be wise to consider concentric diversification in order to diminish the risks associated with a narrow product or service line while retaining heavy investment in the company's basic area of proven ability.

Firms which are categorized in quadrant II need to seriously evaluate the advisability of continuing their present approach to the marketplace. Assuming that a firm has competed long enough to accurately assess the merits of its current grand strategy, there is a need to determine (1) the reasons why its approach is ineffectual and (2) if the company has the capability to compete effectively. Depending on the answers to these questions, the firm should choose one of four grand strategy options: formulation or reformulation of a concentration strategy, horizontal integration, divestiture, or liquidation.

In a rapidly growing market, even a small or relatively weak business is often able to find a profitable niche. Thus, formulation or reformulation of a concentration strategy is usually the first option which should be considered. However, if the firm is lacking either a critical competitive element or sufficient economies of scale needed to achieve competitive cost efficiencies, then a grand strategy which directs the company efforts toward horizontal integration is often a desirable alternative. A final pair of options involve a decision to cease competition in the market or product area. A multiproduct firm may conclude that the goals of its mission are most likely to be achieved if this one business is dropped through divestiture. Not only does this grand strategy eliminate a drain on resources, it may also provide additional funds to further promote alternative business activities. As option of last resort, a firm may decide upon liquidation of the business. In practical terms this means that the business cannot be sold as a going concern and is at best worth only the value of its tangible assets. The decision to liquidate is an undeniable admission of failure by a firm's strategic management and is thus often delayed—to the further detriment of the company.

Strategic managers tend to resist divestiture because it is likely to jeopardize their control of the firm and perhaps even their job security. By the time that the desirability of divestiture is acknowledged, the business has often deteriorated to the point that it fails to attract potential buyers as a business. The consequences of such delays are financially disastrous for the owners of the firm, since a going concern is often valued at multiples greater than the business's simple asset value.

Strategic managers who have a business in the position of quadrant III and who perceive a continued slow-growth market and a relatively weak competitive position usually attempt to decrease their resource commitment to that business. Minimal withdrawal is accomplished through retrenchment, which has the side benefits of making resources available for alternative investments and of motivating employees to increase their efficiency of operations. An alternative strategy is to divert resources from growth in the

business to expansion through investment in other businesses. This approach typically involves either concentric or conglomerate diversification, because the firm usually wishes to enter into more promising arenas of competition than forms of integration or development would allow. The final options for quadrant III businesses are divestiture, if an optimistic buyer can be found, and liquidation.

Quadrant IV businesses, which have a strong competitive position in a slow-growth market, enjoy a basis of strength from which to launch diversified programs into more promising growth areas. With characteristically high cash flow levels and limited internal growth needs, these businesses are in an excellent position for concentric diversification into ventures with their proven business acumen. A second choice is conglomerate diversification, which allows for a spreading of investment risk coupled with freedom from a dilution of managerial attention on the present business. The final option is joint ventures which have special attraction for a multinational firm. Through joint ventures a domestic business is able to gain new competitive advantages in promising new fields while exposing itself to limited risks.

Summary

Before learning how strategic choice decisions are made, it was important to understand the two principal components of any strategic choice, namely, long-term objectives and grand strategy. Such understanding was the purpose of the chapter.

Long-term objectives were defined as statements of results which a business seeks to achieve through its activities over a specified period of time, typically five years. Seven common topics of long-term objectives were discussed: profitability, productivity, competitive position, employee development, employee relations, technological leadership, and public responsibility. It was seen that these, or any other long-term objectives, should exhibit qualities which make them acceptable, flexible, measurable over time, motivating, suitable, understandable, and achievable.

Grand strategies were defined as comprehensive general approaches to guide major actions designed to achieve long-term objectives. Twelve specific grand strategy options were discussed. They included concentration, market development, product development, innovation, horizontal integration, vertical integration, joint ventures, concentric diversifications, conglomerate diversifications, retrenchment/turnaround, divestiture, and liquidation.

Questions for discussion

1. Think of the business community nearest to your college or university. Identify businesses which you believe are using each of the 12 grand strategies.
2. Place each of the 12 businesses which you identified for question 1 into one of the

four quadrants of the grand strategy selection matrix. Discuss the apparent appropriateness of each firm's selected strategy.

3. Write a long-term objective for your school of business which exhibits all seven of the qualities for long-term objectives which were described in this chapter.
4. Distinguish between the following pairs of grand strategies:
   a. Horizontal and vertical integration.
   b. Conglomerate and concentric diversification.
   c. Product development and innovation.
5. Rank each of the 12 grand strategy options on the following three scales:

   High ——————————————— Low

   Cost

   High ——————————————— Low

   Risk of failure

   High ——————————————— Low

   Potential for exceptional growth

6. Identify companies which use one of the eight specific options shown in Figure 7-1 under the grand strategies of concentration, market development, and product development.

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chapter 7 cohesion case

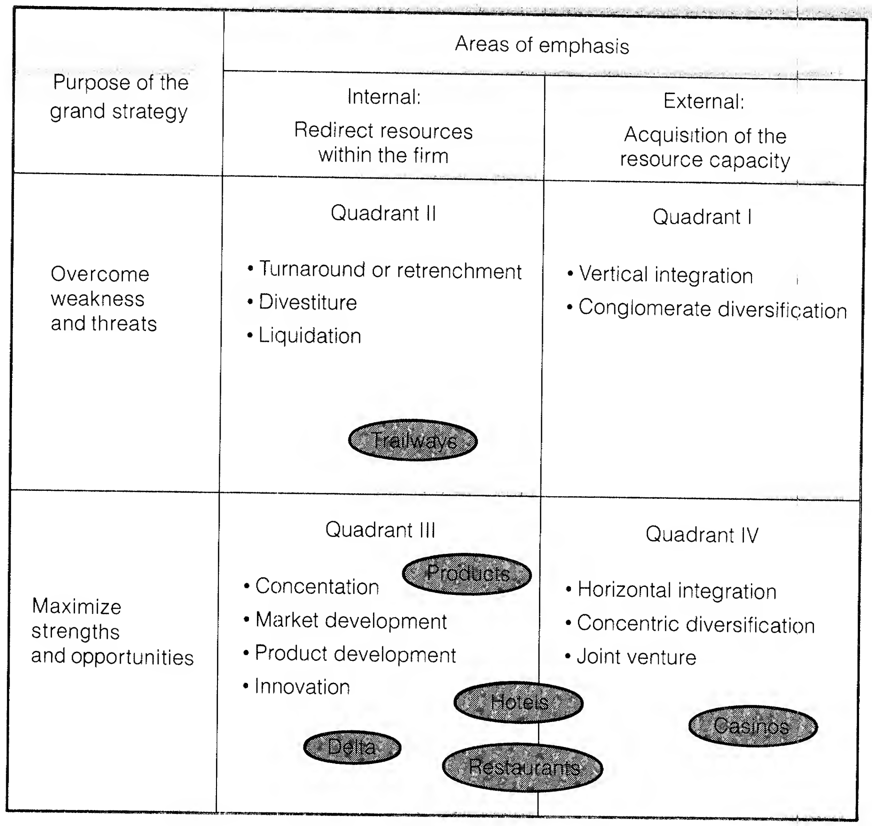
Selection of alternative grand strategies at Holiday Inns, Inc.

Chapter 7 has identified 12 grand strategy options that a firm might consider. Should Holiday Inns, Inc., thoroughly analyze all 12 grand strategies as they apply to the company? Definitely not! This would waste time when several of the options are clearly not appropriate for each of Holiday Inns' business groups. Rather, the objective at this point is to identify a narrow range of logical strategies within each business group which strategists should thoroughly evaluate, leading ultimately to the choice of a future business strategy. While Chapter 8 will focus on the details of evaluation and choice, our purpose here is to illustrate the initial identification of broad strategy options for Holiday Inns.

How is this initial identification accomplished at Holiday Inns? To begin, you must recognize the distinction between corporate and business-level strategy. With both levels applicable at Holiday Inns, you must concentrate your initial identification of alternative strategies at the business level. In other words, you need to identify the alternative grand strategies for each of Holiday Inns' business groups. Subsequent evaluation and choice of business-level strategies will address and decide corporate-level strategy.

For each business group at Holiday Inns, what are the most appropriate grand strategy options? Exhibit 1 provides an answer to this question. It places each business at its appropriate cell on the grand strategy selection matrix, which was discussed in the preceding chapter (Figure 7–7). This placement in turn helps us identify the more appropriate grand strategies for each Holiday Inn business. At Trailways, for example, the key grand strategies we want to evaluate are turnaround/retrenchment or divestiture (quandrant II). In the restaurant group, we would want to evaluate quadrants

exhibit 1
Grand strategy selection matrix for Holiday Inns, Inc.



III and IV since attractive possibilities exist through both areas of emphasis. Thus, we want to look at market development or joint venture and concentration or horizontal integration.

How is the business placed in its appropriate quadrant to identify the appropriate grand strategy alternatives? You must determine how the business fits relative to the two dimensions of the matrix: purpose of the grand strategy and area of emphasis for operational capabilities. To help you understand, we will illustrate the placement of two of Holiday Inns' businesses.

Trailways. Trailways was faced with numerous environmental threats (heavy competition, rising energy costs, lack of terminal subsidy) and significant internal weaknesses (price/cost squeeze, again terminals, inferior image). The primary focus of its ultimate strategy will necessarily have to overcome these weaknesses and threats. To pursue its ultimate strategy, Trailways will depend on and emphasize internal operating capabilities—it already has buses, terminals, and so on—rather than to develop operating

capacity through external acquisitions. Combining these two assessments, Trailways logically fits into quadrant II of the grand strategy selection matrix.

Restaurant group. The restaurant group faces key environmental opportunities (eating-out trends, age trends, single-household trends) and significant internal strengths (franchising expertise, synergy with hotel care, Perkins' northern U.S. position). Logically, the purpose of its grand strategy will be to maximize strengths and opportunities. The area of emphasis for anticipated growth is both internal and external. The company is positioned to carry out company-owned growth (internal emphasis). But the underlying ingredient of the restaurant group is to seek external operating capacity through franchising as well as the possible acquisition of additional chains. Thus, the restaurant group logically fits within two quadrants (III and IV) of the grand strategy selection matrix.

Other groups. You should now be able to surmise why the other Holiday Inns' businesses were placed as shown in Exhibit 1. These decisions can be briefly summarized. The hotel group has attractive strengths and environmental opportunities while it (like restaurants) must emphasize both company-owned (internal) and franchise (external) growth. Delta Steamship has limited but important opportunities (growing Third World markets) and strengths (major U.S.-flag carrier), while depending primarily on internal resource capability. The products group has limited but key strengths/opportunities (captive hotel group) and must emphasize its internal capabilities in pursuit of the chosen strategy. The casinos group, while facing impressive opportunities, must look externally for gaming operational capabilities for the near future. Thus, its placement in quadrant IV.

This analysis suggests that the key grand strategy options for each of Holiday Inns' businesses are as shown in Exhibit 2.

exhibit 2

- Trailways
  - Turnaround/retrenchment
  - Divestiture
- Delta Steamship
  - Concentration
  - Product and market development
  - Innovation
- Casinos
  - Horizontal integration
  - Concentric diversification
  - Joint venture
- Products
  - Concentration
  - Product and market development
  - Innovation
- Hotels and freestanding restaurants — some combination of
  - Concentration
  - Product/market development
  - Innovation

  and
  - Horizontal integration
  - Concentric diversification
  - Joint venture (franchising)

The next Cohesion Case section focuses on the evaluation and ultimate choice among these alternatives for each Holiday Inn business. It will also examine the choice of Holiday Inns' corporate-level strategy as a balancing of the portfolio of business-level options.

chapter 8

Strategy evaluation and choice

THE previous chapter examined basic characteristics of major strategic alternatives which a firm might consider. Several questions remain. How does a firm evaluate alternative strategies? What are some of the diagnostic tools strategists might use to evaluate and identify realistic alternative strategies? What factors influence the ultimate choice of strategy?

These questions will be examined in this chapter. The differences in evaluation at two levels of strategy, corporate strategy and business strategy, will be explored, and the contingency approach to the evaluation and choice of strategy will be considered.

The search for alternative strategies is both incremental and creative. Strategists begin to consider alternatives they are familiar with and think will work. These are usually incremental alterations of past strategies. Systematic comparison of external and internal factors is often used to search for alternative strategies. Creativity can play an important role in this internal/external comparison. Searching for multiple alternatives facilitates systematic comparison of the strengths, weaknesses, risks, and trade-offs of each alternative. By generating several alternatives and systematically evaluating each, a comparative framework is feasible and the quality of the ultimate choice is logically enhanced. Evaluation of alternative strategies is much the same whether considering new alternatives or the old strategy. The focus is the future. Both old and new strategies must be subjected to the same systematic evaluation in order to facilitate a logical choice.

The process of strategy evaluation covers five incremental phases in arriving at strategic choice. Figure 8–1 identifies these phases at the business and corporate strategy level. Strategy evaluation is a judgmental-analytical process seeking to ascertain the future impact of one or more strategies upon corporate (and/or business-unit) performance. The answers to three basic questions are sought:

1. How effective has the existing strategy been?
2. How effective will that strategy be in the future?
3. What will be the effectiveness of selected alternative strategies (or changes in the existing strategy) in the future?

figure 8-1
Phases of the strategy evaluation process

	Corporate-level strategy	*Business-level strategy*
Time ↓	Analysis of the overall company *Portfolio* of businesses in terms of relative business-unit strength *matched* with relative industry attractiveness and stage of development.	Analysis of the *match* between the business's current strategic position (company profile) and the major strategic opportunities and threats (environmental analysis) that exists or will exist in the planning time period.
	Identify the probable corporate performance if the current business-unit portfolio is maintained with their respective strategies.	Examine the probable results of pursuing the current strategy in light of the new business-environment match.
	Compare this projected corporate performance with tentative corporate objectives to identify major performance gaps.	Compare these results with tentative business objectives to identify major performance gaps and strategic concerns.
	Identify alternative portfolios (to include different strategy combinations at the business-unit level) to close performance gaps.	Identify alternative strategies to close performance gaps and confront (or avoid) strategic concerns.
	Evaluate the alternatives and make strategic choice.	Evaluate the alternatives and make strategic choice.

Strategy evaluation at the corporate level

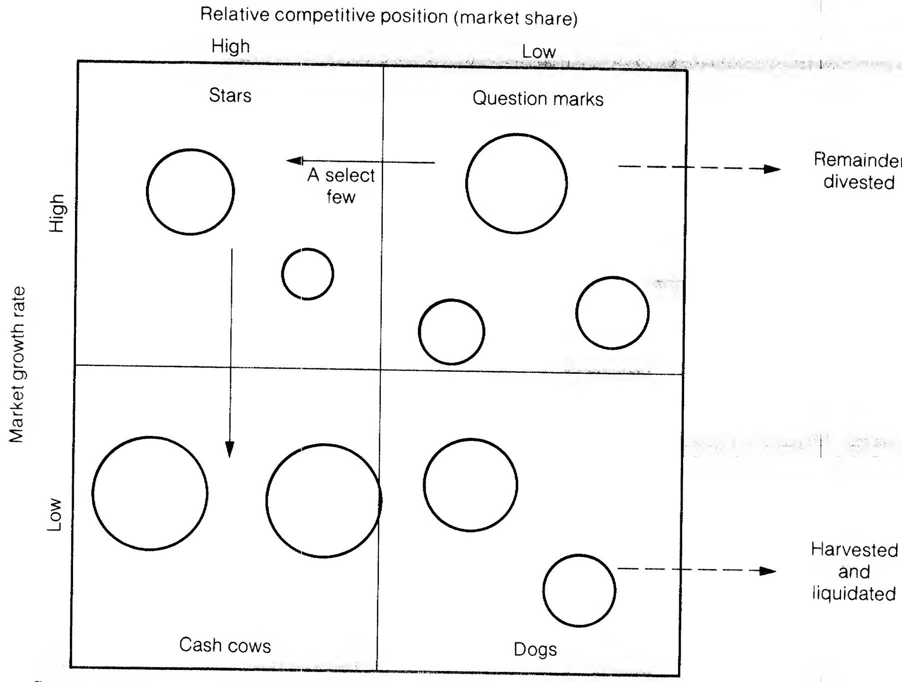
The prevailing method of corporate strategy evaluation in diversified, multi-industry companies is the business portfolio approach. General Electric, for example, has 43 semiautonomous business units. Thus, General Electric must decide how this portfolio of businesses should be managed in order to achieve corporate objectives. This decision, or corporate strategy evaluation, is different from the evaluation of alternative strategies within its business units.

The portfolio approach, with the evaluation of a corporate-level strategy distinct from a business-level strategy, is adaptable to multiproduct/market firms when each product and/or market is managed as a separate business or profit center and where the firm is not dominated by one product/market. Strategy evaluation in dominant product/market companies and single product/market firms would not find corporate strategy considerations separate and distinct from business strategy considerations.

In a broad sense, corporate strategy is concerned with the generation and allocation of corporate resources. The firm's stable of businesses are, to varying degrees, the generators and recipients of these resources. The portfolio approach provides a simple, visual tool to identify and evaluate alternative strategies for the generation and allocation of corporate resources.

One of the earliest portfolio approaches to corporate strategy evaluation was the business portfolio matrix pioneered by the Boston Consulting Group

figure 8-2
Business portfolio matrix



Source: Adapted from Barry Hedley, "Strategy and the Business Portfolio," *Long-Range Planning*, February 1977, p. 10.

(BCG). Figure 8-2 illustrates BCG's business portfolio matrix. This matrix facilitates corporate strategy evaluation of likely "generators" and optimum "users" of corporate resources.

To use the BCG matrix, each of the company's businesses is plotted according to the market growth rate (percentage growth in sales) and its relative competitive position (market share). Each circle represents a business unit. The size of the circle represents the proportion of corporate revenue generated by that business unit. Four cells are differentiated in the BCG matrix with differing implications for corporate-level strategy.

High-growth/high position. The *stars* as BCG as labeled them, are businesses in rapidly growing markets with large market share positions. Stars represent the best long-run opportunities (growth and profitability) in the firm's portfolio. These businesses require substantial investment to maintain (and expand) their dominant position in a growing market. This investment requirement is often in excess of what can be generated internally. Therefore, these businesses are short-term, priority consumers of corporate resources within the overall business portfolio.

Low-growth/high position. *Cash cows* are high market share businesses in maturing, low-growth markets or industries. Because of their strong posi-

tion and minimal reinvestment requirements (for growth), these businesses are often cash generators in excess of their needs. Therefore, these businesses are selectively "milked" as a source of corporate resources for deployment elsewhere (stars and question marks). Cash cows are yesterdays stars, and remain the current foundation of most corporate portfolios. They provide the cash to pay corporate overhead, dividends, and provide debt capacity. They are managed to maintain their strong market share position while efficiently generating excess cash for corporate-wide use.

Low-growth/low position. BCG labeled businesses with low market share and low market growth as the *dogs* in the firm's portfolio. These businesses are in saturated, mature markets with intense competition and low profit margins. Because of their weak position, these businesses are managed for short-term cash flow (through ruthless cost cutting, for example) to supplement corporate-level resource needs. According to the original BCG prescription, they are eventually divested or liquidated once the short-term harvesting is maximized.

Recent research has questioned the notion that all *dogs* should be destined for a divestiture/liquidation strategy.[1] The thrust of this research suggests that *well-managed dogs* turn out to be positive, highly reliable cash generators (although still far less cash-rich than *cows*). The *well-managed dogs,* according to these studies, are those that utilize a strategy combining a narrow business focus, emphasis on high product quality and moderate prices, strenuous cost-cutting and cost control vigilence, and limited advertising. While suggesting that *well-managed dogs* can be a useful component of a business portfolio, these studies warn that ineffective *dogs* should still be considered prime candidates for harvesting, divestiture, or liquidation.

High-growth/low position. Question mark businesses have considerable appeal because of their high-growth rate, yet present questionable profit potential because of a low market share. Question mark businesses are known as cash guzzlers because their cash needs are high as a result of rapid growth, while their cash generation is low due to a small market share. Since the market growth rate is high, a favorable market share (competitive position) should be easier to obtain than with dogs in the portfolio. The corporate portfolio concern is to identify the question marks that are the best recipients of extra corporate resources to seek increased market share and thus movement into the star group. When this long-run movement (from question mark to star) is unlikely, BCG suggests divestment.

BCG's matrix represents a valuable initial development in the portfolio approach to corporate-level strategy evaluation. The goal of the BCG approach is to determine the best corporate strategy in terms of providing a balanced portfolio of business units. An ideal, balanced portfolio would have

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[1] Carlyn Y. Y. Woo and Arnold C. Cooper, "Strategies of Effective Low Market Share Businesses," *Proceedings Academy of Management*, Detroit, 1980, pp. 21–25. Donald Hambrick and Ian MacMillan, "Dogs," *Boardroom Reports,* October 15, 1981, pp. 5–6.

the largest sales in cash cows and stars, with only a few question marks and very few dogs (with favorable cash flow).

While the BCG matrix offers a useful visual analysis of corporate (business portfolio) strategy at different points in time, several limitations exist in the basic BCG matrix paradigm. First, the supposed relationship between relative market share and cash flow may be weak at times. This may be the case when, for example, the effects of experience or scale are small. Second, the supposed relationship between market growth rate and cash flow may be weak when, for example, capital intensity is low or heavy price competition exists. Third, the measurement of market share and the measurement of market growth rate are often difficult to assess accurately, thus creating the potential for distortion or manipulation. Fourth, the market share/market growth axes limit the degree of sophistication in the comparative assessment of business units. Finally, as noted earlier, the options for *dogs* (especially effective ones) may be much broader than the BCG matrix implies.

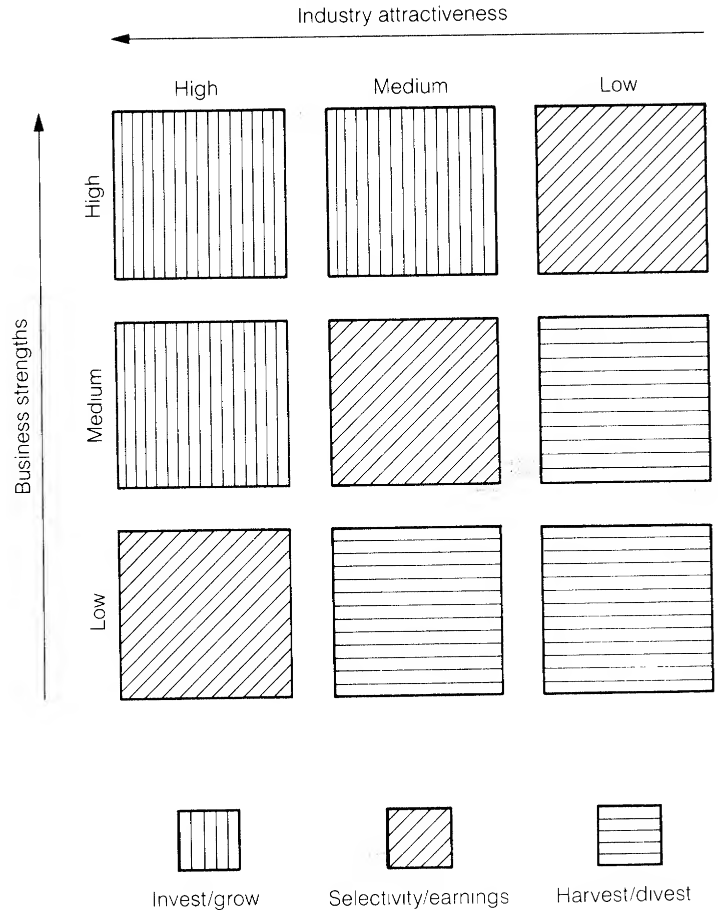
General Electric popularized an adaptation of the BCG approach that attempts to deal with some of the BCG matrix limitations mentioned above. GE's portfolio matrix is presented in Figure 8–3. First, GE uses multiple factors to assess industry attractiveness and business strength, replacing the single measures (market share and market growth, respectively) employed by BCG. Second, GE expanded the matrix from four cells to nine cells—replacing the high/low axes with high/medium/low axes in order to increase the matrix's sophistication. The resource allocation decisions remain quite similar to the BCG approach. These are highlighted in Figure 8–3. The main advance of GE's model is that it facilitates finer distinction between business portfolio positions.

Charles Hofer has made further improvements in the portfolio approach to corporate strategy evaluation.[2] Concerned that the GE matrix did not clearly depict the position of new businesses about to emerge as winners in new industries, Hofer proposed a 15-cell matrix to evaluate corporate portfolios. Figure 8–4 illustrates Hofer's product/market evolution portfolio matrix in which businesses are plotted in terms of their *competitive position* and their *stage of product/market evolution*. Differing from BCG and GE matrices, the circles represent the size of industries (or product/market segments) involved, and the wedges represent the market share of the business unit. Looking at Figure 8–4, several strategic considerations emerge regarding the business portfolio.

1. Business A appears to be an emerging star, and thus a target for excess resource allocation—especially to strengthen its competitive position in light of its strong market share.
2. Business B presents much the same scenario as business A except that

[2] C. W. Hofer, "Conceptual Constructs for Formulating Corporate and Business Strategies" (Boston: Intercollegiate Case Clearing House, 9–378–754, 1977), p. 3.

figure 8-3
General Electric's planning grid

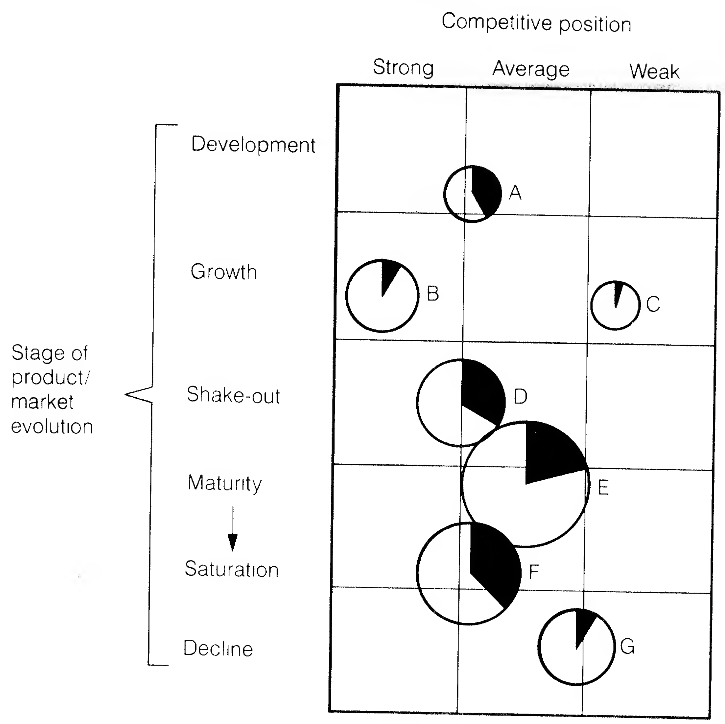


corporate resource allocation would probably be contingent on determining why it has been unable to obtain a higher market share, given its strong competitive position, and the presentation of sound plans to rectify this deficiency.

3. Business F and, to a lesser extent, business E represent cash cows within the corporate portfolio and would be key targets for corporate resource generation.
4. Business G appears to be an emerging dog, managed for short-term cash flow generation (corporate resource generator) and eventual divestment, or liquidation.

The product/market evolution continuum adds a useful dimension to the identification, analysis, and evaluation of corporate-level portfolio strategies:

figure 8-4
A product market evolution portfolio matrix

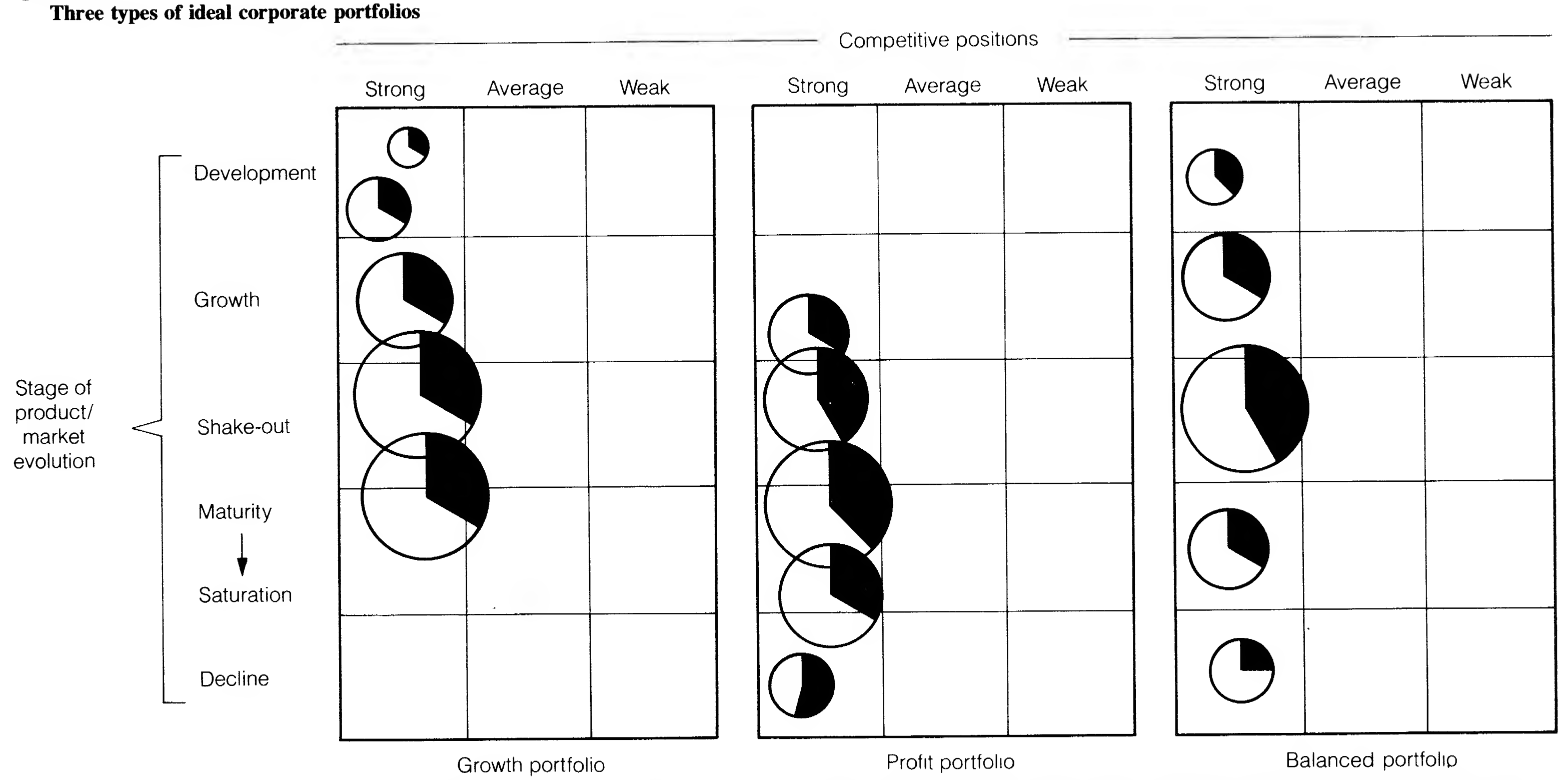


Source: Adapted from C. W. Hofer, "Conceptual Constructs for Formulating Corporate and Business Strategies" (Boston: Intercollegiate Case Clearing House, 9-378-754, 1977), p. 3.

While the variety of alternative portfolio strategies is infinite, Hofer and Schendel suggest that most corporate-level portfolio strategies are variations of one of three ideal portfolios: (1) growth portfolios, (2) profit portfolios, and (3) balanced portfolios.[3] Figure 8-5 illustrates these ideal portfolios. As ideal types, these portfolios represent different portfolio goals that a company might pursue through its strategic allocation of corporate resources. In the last two decades, for example, large cigarette companies (like R. J. Reynolds or Phillip Morris) sought profit portfolios in order to maximize the generation of excess corporate resources with which to eventually acquire (and sustain) new businesses in early product/market evolution or turnaround candidates in existing product/markets. Phillip Morris's acquisition and successful development of Miller beer is an example. With oil revenues generating substantial corporate resources, large oil companies (such as Exxon and Gulf) have become "energy" companies seeking growth

[3] C. W. Hofer, and Dan Schendel, *Strategy Formulation: Analytical Concepts* (St. Paul, Minn.: West Publishing, 1978).

figure 8–5
Three types of ideal corporate portfolios



Source: Reproduced by permission from *Strategy Formulation: Analytical Concepts* by Charles W. Hofer and Dan Schendel, copyright © 1978 by West Publishing Company. All rights reserved.

portfolios of businesses in alternative, emerging energy technologies. Most multi-industry firms seek corporate-level portfolio strategies that are closest to the balanced portfolio. They seek a balance of sufficient cash cows and short-term cash flow maximizers with a small number of stars and developing winners in order to maximize internal control of resource procurement needs. GE is a good example of a balanced portfolio pursurer. Strategy in Action 8–1 describes the learning probe approach of Anheuser-Busch as it seeks to evaluate alternative portfolios in its choice of future corporate strategy.

strategy in action, 8–1
Anheuser-Busch's Choice of Strategy for the 1980s

If Anheuser-Busch isn't careful, its success in the beer business will turn into an embarrassment of riches by 1985. By then the brewer plans to have completed a $2 billion, five-year expansion program that will increase its capacity 40 percent and add significantly to its 29 percent share of the beer market. Profits may well be double 1980s expected $169 million.

The St. Louis brewer is evaluating three options:

1. Diversification.
2. Overseas expansion.
3. A combination of both.

To evaluate and ultimately choose its strategy, Anheuser-Busch is using what its managers call learning probes—miniventures or experiments relative to each alternative strategy.

Anheuser-Busch's first learning probe was into the soft-drink business. From the start, the test was the subject of considerable second-guessing. "Would Coke and Pepsi enter the beer industry from scratch and go up against Anheuser-Busch and Miller?" asks a skeptical rival brewer. "I think the answer would be no."

Anheuser-Busch's answer, after two years of testing, also may be no. "We've learned it's a competitive jungle out there," says August Busch III, chairman, "just like us and Miller in the brewing industry."

His experience stems primarily from Root 66 beer and its sugar-free version—which have been sold in five cities since the summer of 1979. Busch says the drinks have a respectable market share, but competitors contend it was achieved mostly through cents-off discounts offered to consumers.

Anheuser-Busch's first foray into soft drinks was the ill-fated Chelsea,

strategy in action, 8-1 ***(continued)***

a citrus beverage that could have had the snob appeal and profit margin of Perrier. Introduced in September 1978, Chelsea was hooted off the market by nurses and others who objected to the alcoholic content (0.4 percent) and beer-like appearance of the "not-so-soft drink."

Company officials are reluctant to disclose much about the prospects for their learning probes, but last year Jerry E. Ritter, vice president of finance and treasurer, acknowledged that "beer earnings and share growth may slow as we approach our long-term 40 percent market share goal." The brewer is planning for that day, he said, by "getting our feet wet in new business areas, not massive diversification efforts."

Anheuser-Busch hopes to trade on its established strengths. It knows a lot about manufacturing and packaging beverages and then marketing them (ad spending last year was about $190 million). Its most powerful asset is its distribution system: 950 beer wholesalers with fleets of trucks and sales links to bars, restaurants, supermarkets, and liquor stores.

Beer distributors were used for the soft-drink test and also for a look at the snack business, where Anheuser-Busch is selling its new Eagle line in bars. One sign of success: distribution is being widened to 24 cities from a handful.

The third learning probe, less prominent than snacks or soda but more encouraging to several followers of Anheuser-Busch, is the company's development of Sesame Place educational parks in conjunction with Children's Television Workshop, producers of "Sesame Street."

With no rides and only three to four acres—compared to at least 100 acres for such theme parks as Disneyland or the brewer's two Busch Gardens—Sesame Place doesn't require too much capital. The first park, complete with Big Bird bridge entranceway, opened last summer near Philadelphia. The company says its major concern so far has been that people stayed 5 hours, instead of a projected 2½, to play the games.

The other alternative strategy, which requires even less capital and could pay off sooner than the others, is overseas expansion of the brewing business. International sales account for less than 1 percent of Anheuser-Busch's beer volume.

Industry experts see obvious problems in all these attempts. Foreign protective tariffs and laws would make exported beers or brews that might be produced in an Anheuser-Busch plant overseas high priced. Licensing foreign brewers to make Anheuser-Busch products might be the only feasible alternative. And, asks one beer marketing expert, "What makes them think foreigners crave American beer?"

The big sales and profits in snacks are in supermarkets, which the King of Beers hasn't tackled yet; it would find a vigorous defense there from snack king Frito-Lay. Entertainment parks may work, but would they add significantly to the company's revenue, estimated at $3.3 billion last year?

A likely possibility is that Anheuser-Busch will use its knowledge from

strategy in action, 8–1 ***(concluded)***

the experiments to guide it in future acquistions. "We'll have acquired a base of personnel and experience to use," Ritter said. "We aren't under the gun to diversify for the next five years."

But analysts say that large acquisitions will be tough to finance. The company's heavy load of debt would make it hard to add more, and much of Anheuser-Busch's cash before 1985 will have to pay off current brewery expansion. The company's conservative management probably would be reluctant to dilute earnings by using its stock for an acquisition.

What about Anheuser-Busch's rival, Miller Brewing, which faces similar problems down the road as beer industry growth slows? As part of diversified Philip Morris, Miller can spread its cash at Seven-Up, which Philip Morris hopes will benefit from Miller just as Miller expanded with profits from the company's tobacco business.

Source: "If Anheuser-Busch Gets Its Way, Saying 'Bud' Won't Say It All," *The Wall Street Journal,* January 15, 1981, p. 25.

The portfolio approach is a useful means of evaluating alternative corporate-level strategies in multi-industry companies. Its visual appeal notwithstanding, the evaluative power of the portfolio approach is predicated upon a thorough and comparative analysis of the industry attractiveness, competitive position, and product/market evolution of each business unit. Furthermore, this portfolio evaluation must be routinely and repetitively conducted. In this way, the effectiveness of resource generation and allocation decisions in terms of achieving corporate objectives can be monitored, updated, and altered.

Once alternative portfolio strategies have been evaluated, a choice must be made. Furthermore, basic decisions on the allocation of corporate resources and the general manner in which a business unit will be managed (as a cash cow, for example) do not make things happen. Each business unit must evaluate and implement business- and functional-level strategies.

Strategy evaluation at the business level

Once business units (in a multi-industry firm) have been identified as cash cows, stars, or dogs, evaluation and selection of alternative strategies is far from complete. Each business unit must identify and evaluate alternative business strategies in the context of their specific industry and capabilities. If a business unit has been identified as a resource generator or cash cow within the corporate portfolio strategy, several alternative strategies might be available to the business unit in serving this role. Strategy evaluation at the business level in multi-industry firms' business units is essentially the same as strategy evaluation in single product/service or dominant product/service firms, regardless of size.

Business-level strategy evaluation focuses upon the match between the business's strengths and weaknesses and the environmental/industry opportunities and threats. Alternative strategies are evaluated for consistency between a business's external and internal dimensions in terms of both the current situation and the forecasted future situation. A strategy is sought which is the most appropriate use of business resources and capacities within the current and predicted constraints imposed by its external, competitive environment. Thus a basic approach to the evaluation of alternative strategies is a systematic comparison of the environmental/industry analysis and the company profile.

Environmental/industry analysis

A critical step in the evaluation of alternative business strategies is a thorough analysis of the industry in which the firm competes (or is considering competing). A thorough industry analysis provides the strategists with important information with which to evaluate alternative strategies. Such information includes:

1. An identification of key things a firm must do to successfully compete in product/markets of this industry.
2. Determination of the firm's competitive position in the industry and important considerations regarding its key competition.
3. An estimation of the future changes in the industry and the implications regarding segmentation, competition, technology, barriers to entry, and critical success factors.

Such information, particularly when combined with an internal analysis of the firm, provides basic criteria with which to evaluate alternative strategies the firm is considering.

Figure 8–6 provides a list of questions that comprise a thorough environmental/industry analysis. The importance or relevance of individual questions may vary according to specific situations. The breadth of coverage, however, is important for any situation where business strategies are being evaluated.

At the strategy evaluation phase, the questions for environmental/industry analysis serve as guidelines for an in-depth focus on the specific industry and product/market segment(s) of the business. This is done in an evaluative manner seeking to identify the relative importance of various factors as determinants of future success in the industry. Most of the questions in Figure 8–6 are straightforward and do not require further elaboration. Also, Chapters 5 and 6 examined general considerations associated with identifying and forecasting environmental conditions. However, the stages of product/market evolution as a strategy evaluation tool merits further consideration.

figure 8–6
Guide to an environmental/industry analysis

1. Economic characteristics of the industry:

   What is the stage of industry evolution?

   What is the degree of buyer/seller concentration? Does this vary along different points in the vertical chain?

   What is the pattern of vertical integration? Where is the greatest value added in the vertical chain?

   What is the nature of industry growth and profitability?

   What are key trends and changes in the above dimensions of this industry?

2. Product/market structure:

   What product/market segments exist in this industry? What is the size of these segments? What stage are the products in the life cycle?

   How are markets segmented in this industry? Is segmentation stable or currently evolving?

   What are the needs and characteristics of customers in the various segments? What is the degree of customer concentration and market penetration?

   What are key trends or changes in the above characteristics?

3. Marketing/distribution:

   What are the basic channels of distribution? How many steps? Are there multiple channels? Which are the most important? What is their size and growth rate? How are they changing?

   What is the nature and role of advertising? media? sales force? technical and service support? Which appear most important? What are future trends in these aspects and their relative importance?

   How important is the marketing function to profitability in this industry? What is the proportion of marketing costs in successful firms? less successful firms? How is this changing?

   What role do such things as product/service differentiation, brand loyalty, trademarks, copyrights, reputation, unique features, and obsolescence play in customer decision?

   What barriers to entry are presented by the marketing function: marketing costs, franchising, transportation, and so on.

4. Financial considerations:

   What are the capital investment requirements? Do they present significant barriers to entry or exit?

   What is the capital structure of the industry? How is it changing? What is the importance of internal versus external funding? What capital markets are most frequently used?

   What are the cash flow and working capital needs? How are they influenced by business/seasonality cycles? What are the short-term/long-term borrowing requirements?

   What are typical margins? pricing structures? sensitivity to price/cost changes? What is the time requirement and competitive response to cost increases via price changes?

figure 8-6 ***(concluded)***

5. Production/operations considerations:

   What is the nature of industry manufacturing (or service delivery) systems? the degree of integration? What are key changes and trends in this regard?

   What is the role of technological change? degree of automation? human resources required? their availability? the role of labor unions?

   What is the expected life and adaptability of plant and equipment?

   What is the relationship between capacity utilization and profit margins? breakeven point?

   What are transportation/logistics requirements? Are markets concentrated? What are changes and trends in this dimension, especially in light of energy costs?

6. Competition:

   What is the competitive structure of this industry? Is it concentrated or dispersed? What is the position of each competitor in terms of products offered, markets competing in, market shares, growth, and competitive emphasis.

   Which firms are most successful? least successful? What do they do (or don't do) that distinguishes them? What are the roles of pricing, marketing expenditures, technology, and capital investment in this distinction?

   How intense is competition by market segment? Are there other contingencies on competitive intensity such as geography, regional versus national, and so forth?

   What are the trends in competition? Are the barriers to entry identified earlier continuing to influence competition? Are substitute goods, services, or technologies available?

7. Government/social environment:

   What are key government regulations for this industry? federal, state, or local level? How does the regulation influence industry members? What are trends and changes in the regulatory environment?

   What special interest or community groups are important to this industry?

8. Important competencies for success:

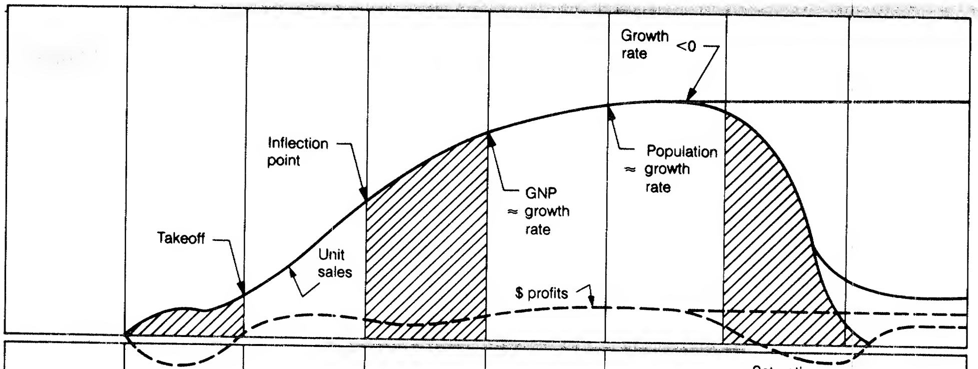
   What are important determinants of success in this industry based upon the seven dimensions presented above? What must a firm be sure to do? Does this vary by market segment, location, customers, or other key factors?

   How will these determinants constrain strategy options? What tradeoffs are feasible?

Stages of product/market evolution. The requirements for success in product/market segments evolve and change in importance over time. As a result, business strategists must understand the changing pattern of determinants of success associated with different stages in product/market evolution if they are to effectively identify determinants of success and evaluate alternative business strategies.

Figure 8-7 depicts seven stages of product/market evolution and typical

figure 8-7
The fundamental stages of product/market evolution



Stage	Development	Growth	Shakeout	Maturity	Saturation		
					Saturation	Decline	Petrification
Market growth rate	Slight	Very large	Large	GNP growth	Population growth	Negative	Slight to none
Change in growth rate	Little	Increases rapidly	Decreases rapidly	Decreases slowly	Little	Decreases rapidly, then slow. May increase, then slow*	Little
Number of segments	Very few	Some	Some	Some - to - many		Few	Few
Technological change in product design	Very great	Great	Moderate	Slight	Slight†	Slight	Slight
Technological change in process design	Slight	Slight/ moderate	Very great	Great moderate	Slight	Slight	Slight
Major functional concern	Research and development	Engineering	Production	Marketing-distribution-finance		Finance	Marketing and finance

* The rate of change of the market growth rate usually only increases during the decline stage for these products that do not die, i.e., that enter the petrification stage of evolution.

† Although the rate of technological change in the basic design of the product is usually low during this stage of market evolution, the probability of a major breakthrough to a different kind of product that performs the same function increases substantially during this period.

Source: C. W. Hofer, "Conceptual Constructs for Formulating Corporate and Business Strategy" (Boston: Intercollegiate Case Clearing House, 9-378-754, 1977), p. 7.

changes that occur in basic dimensions that are often associated with business success. In the early development of a product/market, for example, there is minimal growth in sales, major R&D emphasis, rapid technological change in the product, operating losses, and a need for sufficient resources or slack to support a temporarily unprofitable operation. This stage is often

followed by rapid growth as technology is perfected and the product profitably produced and distributed. As the product/market moves into the shakeout stage, several changes occur in basic industry dimensions. Market growth continues, but at a rapidly decreasing rate. The number of market segments begins to expand, while technological change in product design slows considerably. Technological change in process design becomes intense as the many competitors seek to provide the product in the most efficient manner. Where R&D was critical in the development stage, production has now become critical to the business's continued success.

The scenario of the remaining stages is relatively straightforward in Figure 8–7. The important thing to realize, especially as illustrated in the preceding discussion of the development and shakeout stages, is that the relative importance of various dimensions of an industry (or product/market) as determinants of success differ across stages of product/market evolution. Thus it is important to incorporate stage of evolution considerations in the industry analysis phase of business strategy evaluation. For different stages, Figure 8–7 suggests different dimensions are particularly deserving of in-depth consideration in the industry analysis.

For businesses contemplating a major change in their current strategy, the stages of evolution procedure offers additional assistance. Research by Abell and Hofer suggests that there are "strategic windows" in many industries.[4] These strategic windows are limited periods of time (in industry evolution) during which a business might successfully change its current competitive position through the adoption of new strategy. They identify the strategic windows as three specific stages of product/market evolution: development, shakeout, and decline. It is during these three stages (time periods) that the basic nature of industry competition changes, as can be seen in Figure 8–7. With the basic determinants of competition changing, industry leaders are susceptible to new entrants or emerging competitors with effective strategies for addressing new (or changing) market needs and competitive dimensions.

The environmental/industry analysis and such tools as the stages of product/market evolution seek to identify key determinants of success for the industry and product/market segments within the industry. This analysis, when compared with an analysis of the business's strengths and weaknesses relative to key competencies, provides the basis for comparative evaluation of alternative business strategies.

Analyzing the business's competencies: The company profile

Once the environmental/industry analysis is complete, the next step in the evaluation of alternative strategies is an internal audit of the business's

[4] Derek F. Abell, "Strategic Windows," *Journal of Marketing*, (July 1978, pp. 21–26; and C. W. Hofer et al., *Strategic Management* (St. Paul, Minn.: West Publishing, 1980), p. 17.

competencies. This audit is not separate and distinct from the industry analysis. Rather, the conclusions from the industry analysis suggest important dimensions on which the business must be examined. The purpose of this internal analysis is to examine the business's competencies and determine whether they represent strengths or weaknesses for the firm in relation to its competition and the requirements for success emanating from the industry analysis.

Figure 8–8 provides a checklist of items that should be addressed in the internal analysis. The importance or relevance of specific factors will vary for different business situations. The breadth of coverage and general topics identified are critical in order to ensure full analysis and identification of a business's strengths and weaknesses. The identification and evaluation of internal factors was discussed in detail in Chapter 6.

figure 8–8
Checklist for analysis of a business's competencies

1. Marketing/distribution factors:

   What is the firm's market share(s) in this industry? How does this compare with key competitors? Is it increasing or decreasing? What is its product mix and how are products positioned relative to growth/declining markets?

   What is the business's standing with key customer groups? What distinguishes demand for its products or services? How does this compare with key competitors? How is this changing?

   What is the firm's pricing strategy? Is this compatible with market(s) trends?

   What are the most important channels of distribution in this firm? Are they cost effective? Do they provide maximum access to customer demand? Are they positioned for future market trends?

   What is the role of advertising in the marketing effort? How does this compare to market and competitive conditions?

   What strengths do the sales force/organization offer? What is the level of sales concentration (to a few customers?)? Is this vulnerable? Can it be easily changed?

   What key patents, franchises, or similar advantages are available?

2. Financial/accounting factors:

   What is the current financial health of the firm? ratio analysis? comparison to competitors and demands of the industry? total financial resources and strength?

   What is the firm's cost of capital relative to competitors and industry? stock price? P/E ratio? dividend policy?

   Does the firm have an effective capital structure relative to competition and industry demands? Does it suggest flexibility in raising additional capital? financial leverage?

   Are there favorable (or unfavorable) future financial commitments by the firm? What limitations or opportunities do they pose?

   Does the firm have effective planning systems for financial, capital budgeting, and working capital considerations? Are they an efficient part of the management system?

figure 8-8 ***(concluded)***

3. Production/operations management:

   What is the firm's operating cost relative to the industry and key competitors? Is it efficiently and effectively using capacity? facilities?

   Does the capacity exist to meet additional market demands? What costs/time constraints are associated with expanding capacity?

   Is technology, process design, supplier dependence, and location advantageous relative to competition and industry/market trends?

   Are effective procedures for inventory control, scheduling, quality control, and maintenance a part of daily management systems? Is this consistent with industry standards?

   What is the level of R&D? How does this compare with the industry and key competitors?

4. Human resources management/organizational factors:

   Does the firm have an experienced and effective management team? Is its middle management experienced and competent? Does it possess unique managerial expertise relative to the industry or competition?

   Are the employees skilled and productive? Does the firm have effective union relations?

   What are the firm's labor and overhead cost relative to key competitors? Is this component easily managed?

   Is the organizational structure appropriate for industry conditions? Is design capable of rapid organizational change?

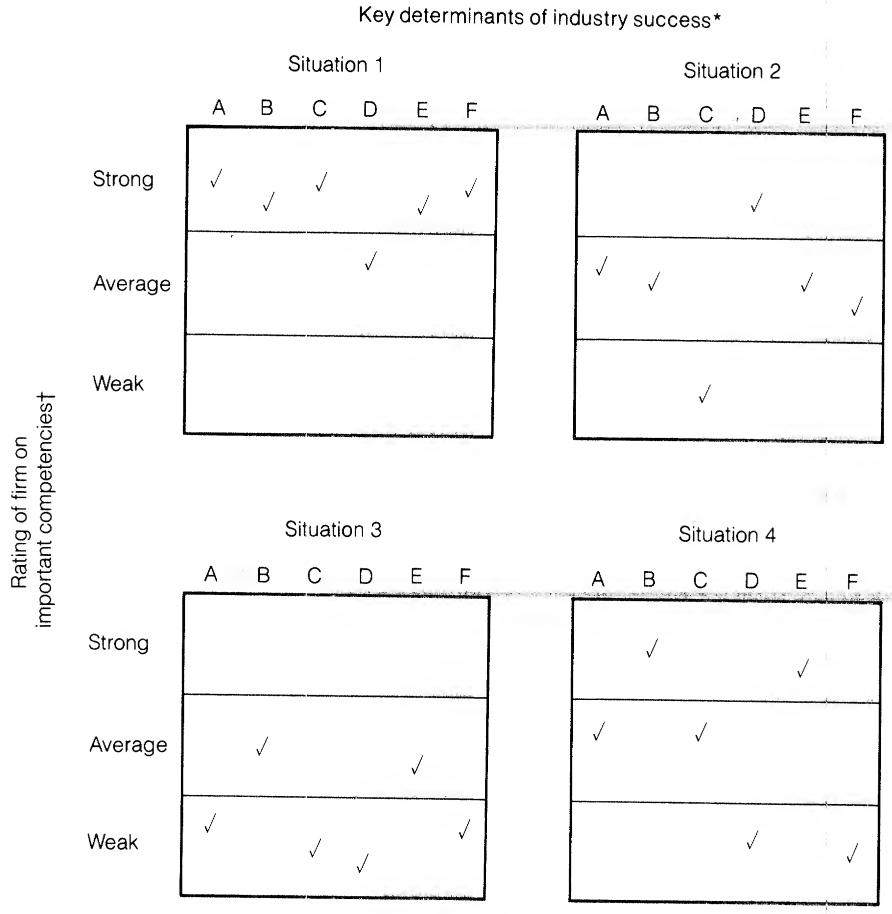
Comparing the industry analysis and company profile: Business strategy evaluation

A systematic comparison of the environmental/industry analysis and the profile of business strengths and weaknesses is the underlying basis for any approach to business strategy evaluation. The industry analysis has narrowed the focus to the relative importance of selected, critical factors (or competencies) in determining successful participation in the industry and its various market segments. The determination of present and future importance has been refined by such tools as stage of product/market evolution and strategic forecasting. The company profile has identified key strengths and weaknesses of the business, what its distinct competencies are, particularly relative to the key factors identified in the industry analysis. The next step is to evaluate the fit of alternative strategies in a systematic comparison of the industry and business analyses, as illustrated in Figure 8–9.

The four situations in Figure 8–9 are illustrative of the outcome of comparing the industry analysis and the company profile. Obviously, many additional outcomes are possible. These four are chosen to illustrate business strategy evaluation.

Situation 1. The firm in situation 1 occupies a strong competitive position. Its distinctive competencies match favorably with the determinants of

figure 8–9
Business-level strategy evaluation



* A, B, C, D, E, and F represent key determinants of success in an industry or, where the industry is not dominanted by one major product/market, key determinants of success in a particular segment. Using the domestic airline passenger industry as an example, A–F would represent high-density routes, energy-efficient aircraft, hub location, market share, financial/debt capacity, and labor cost/relations, respectively.

† This dimension represents the internal analysis of a business's competencies in light of the key determinants of success in the industry or product market segment. Four typical business situations are represented here. Each √ shows the strength of a business's competency relative to a key determinant of success in the industry.

industry (or product/market segment) success. A firm in this position should pursue an aggressive strategy exploiting its key strengths. Several characteristics of an appropriate strategy in this situation would include: grow, seek dominance, maximize investment, expand market share, diversify, and reinforce distinct competencies. Situation 1 would support strategies that challenge rival firms head on, even where they are strong. Following the analogy of the airline industry suggested in Figure 8–9, a firm in situation 1

would be Delta Airlines. With its strong financial position, hub location, relatively efficient aircraft, low labor costs, and improving market share, Delta strategists narrow alternative strategies to growth-oriented, share increasing ones that exploit their cost advantages.

Situation 2. The firm in situation 2 possesses moderate competence in key factors associated with industry (or product/market) success. Firms in this situation might be inclined toward stable growth strategies, seeking to maintain position, minimize risk, and minimize the firm's dependence on weaker competencies. Specialization, selected growth via segmentation, and functional strategies to improve critical competencies would often be characteristics of appropriate strategies for situation 2 firms. Contrary to situation 1, situation 2 firms would be unlikely to choose strategies that attack rival firms where they are strong. Rather, strategies should be sought that attack rival's weaknesses, and less emphasized market segments. Again, using the airline analogy, Eastern illustrates a situation 2 firm. It has several high-density routes, yet Eastern's overall fleet is not energy efficient. Its hub location, market share, financial/debt capacity, and labor cost/relations, though adequate, are not nearly as strong as Delta's. Eastern strategists would logically prefer to protect key (profitable) routes, maintain current position, selectively seek new segments for limited growth, and seek to improve their competence on such factors as aircraft efficiency and financial strength. More aggressive strategies might call for greater competence than Eastern can muster, spelling future disaster.

Situation 3. The firm in situation 3 occupies a weak competitive position. Its level of competence relative to key determinants of industry (or product/market) success is marginal to poor on each factor. A firm in this situation is rather limited and appropriately narrows alternative choices to defensive-oriented strategies. Retrenchment, cost cutting, and maintenance of minor market-segment positions characterize situation 3 strategies. Serious consideration must be given to divestiture and/or liquidation where the potential for improvement is unrealistic. Turnaround strategies may be appropriate where one or more competencies have the potential for improvement.

Braniff offers a situation 3 competitor in the airline industry. On the key success factors suggested in Figure 8–9 for the airline industry, Braniff is consistently weak. This is acutely true regarding its overextended, precarious financial condition. As a result, Braniff has chosen to concentrate on a limited route structure, gradually divest itself of a large portion of its fleet, cut costs wherever possible, and stabilize profitability around a small market share.

Situation 4. The firm in situation 4 presents a broad dispersion in the match of its competencies with industry (or product/market) success requirements. It is strong on selected determinants of success while weak on others. Such a position lends itself to the strategy evaluation axiom: maximize opportunities and strengths while minimizing threats and weak-

nesses. Translated, firms in this situation should seek strategies where success depends upon the competencies in which the firm is strong and not where the firm is weak. Realistically, for a firm to pursue an aggressive, growth-oriented strategy based upon key strengths (like reputation and technology, for example) often requires it to assume higher levels of risk with a necessary dependence upon weaker competencies (like location or financial capacity) if the strategy is to be successful. Firms in this situation are often the question marks in corporate-level portfolios.

USAir might well be a situation 4 firm in the airline industry. At the advent of deregulation, USAir was basically a regional airline. As such, it had a fleet dominated by smaller, fuel efficient aircraft. Considering the domestic passenger airline industry, USAir had strong competence with energy efficient aircraft and low labor costs, weak competence regarding financial/debt capacity and hub location, and moderate-to-poor capacity regarding market share and high-density routes. USAir has adopted a strategy of selective, stable growth. They have pursued shorter, secondary routes which major airlines are abandoning due to cost considerations. As USAir builds it market share, it is intermittently moving into more popular (high-density) routes on a selective basis. Indeed USAir appears to have adopted a selective growth strategy based upon maximizing strengths and minimizing weaknesses within circumstances similar to situation 4.

These four situations illustrate the comparative framework through which industry analysis and company profile are used to evaluate alternative strategies. This evaluation is an iterative, narrowing process. Several questions guide this process:

Which strategic alternative(s) offer the most effective match between industry (or product/market segment) demands and the firm's competencies?

Given industry conditions, does the strategy(s) call for greater competence(s) than the firm can reasonably provide? Do any of the alternatives inadequately exploit key advantages of the firm?

How flexible are alternative strategies in adapting to potential long-term threats or opportunities on the horizon?

What is the realistic contribution of alternative strategies to short- and long-term performance goals of the firm?

What implementation (administrative, operational, etc.) difficulties are associated with alternative strategies?

Which alternatives offer key competitive advantages/disadvantages? What is the level of vulnerability to adverse competitive reaction?

This comparative evaluation is often judgmental, influenced by factors such as managerial attitudes toward risk. In situation 2, for example, risk-prone managers might narrow alternatives to more aggressive ones that stretch their dependence upon moderate-level competencies. Risk-averse

managers, on the other hand, might eliminate such alternatives early in the evaluation process. Strategy in Action 8–2 illustrates the evaluation and choice of strategy at the nation's fifth largest fast-food outlet, Pizza Hut.

Ultimately a choice must be made. Strategic choice is influenced by many factors in addition to risk orientation. Such factors as the degree of external

strategy in action, 8–2
Strategy Evaluation and Choice at Pizza Hut

Pizza Hut was a bigger headache than ever was imagined by Donald Smith, the 40-year-old fast-food crackerjack PepsiCo hired in May 1980 to fix its ailing restaurant chain. Three months later, Smith made the following remarks when he inspected a Pizza Hut in Atlanta:

"Pizzas today take too long to cook; these aren't even fast-food restaurants," he said, slowly downing his ninth pizza slice of the afternoon. "And these breadsticks are a little oily, don't you think?" Cavatini, Pizza Hut's pasta invention, is "a terrible product," he said.

Nitpicking is a predilection of Smith, whose hearty appetite for detail helped him to rejuvenate Burger King during his 3½ years as president, and before that to climb to one of the highest posts at McDonald's, where he'd started as a management trainee 11½ years earlier. His interest in minutiae also won him the admiration of PepsiCo chairman Donald Kendall, who says, "Not many guys who want to learn a business will go out and cook tacos for a week to learn."

Now, after six months of nibbling pizzas and poking around 300 of Pizza Hut's 4,002 outlets, Smith is ready to start his toughest—and most sweeping—turnaround campaign. His plan: to test more than 100 changes, including new menu and decor ideas, before starting a 2½-year, $100 million overhaul.

When PepsiCo bought Pizza Hut in 1977 in a stock swap worth more than $300 million, the restaurant chain, then 18 years old, was thriving. Since then, unit sales have stagnated as customers fled from its inconsistent quality and relatively high prices. Operating profits of the 2,009 company-owned Pizza Huts (the rest are franchised) fell to $43.7 million in 1978 and $26.4 million in 1979 from the 1977 peak of $56.6 million, according to estimates by Emanuel Goldman, an analyst for Sanford C. Bernstein & Co.

Per store sales of $250,000 are well below the fast-food industry average of $434,823. Competition is increasing from smaller chains, which are invading the company's Midwest stronghold, and from independent mom-and-pop pizzerias, which still claim more than half the market.

strategy in action, 8–2 ***(concluded)***

"Overall, Pizza Hut's operations are a little worse than I expected," Smith concedes. Still, he is optimistic. "The pizza business is somewhat like the hamburger business 25 years ago," he says. "There's tremendous potential here." He was lured from Pillsbury's Burger King by a salary rumored to be $350,000 a year, an increase of at least one third, and what he describes as his fondness for "doing something with unfulfilled potential."

Much of Pizza Hut's growth in its pre-PepsiCo days was through the addition of new outlets. There isn't much room in the United States for more Pizza Huts, so the chain's only option is to wring more sales and profits from its existing network.

To fulfill Pizza Hut's potential, Smith wants to create two restaurants in one: a speedier lunch place and an expanded-menu, quality dinner house.

A major feature of his plan is a breakthrough acceleration of pizza cooking time—to about five minutes from 12 to 18—that Smith hopes will transform lunch into truly *fast* food. To further speed the midday flow of customers, Smith will experiment with cafeteria-style, instead of sit-down, ordering. Supper changes to be tested include pasta bars and sundae bars.

No detail will be neglected. Screaming red roofs may be replaced by brown-painted shingles, which would be costlier than repainting the existing roofs but more pleasing to Smith's eye. Also under study for refurbishing: Pizza Hut's seating, lighting, landscaping, and even sidewalks.

Another problem is underpaid managers at Pizza Hut restaurants. Smith already has raised the minimum starting salary for assistant managers 30 percent to $11,000. Store managers' paperwork has been cut to about 12 hours a week from 27 through the elimination of such tasks as daily inventory counts. Says Smith, "You don't need to count black olives every day."

Smith's goal is to add $100,000 to the average Pizza Hut's annual sales and to increase the chain's less than 5 percent return on assets to more than 10 percent by 1983. That would add roughly $80 million to PepsiCo's pretax profits and could restore some of the prestige that Pizza Hut has cost its parent on Wall Street.

A turnaround would benefit Smith, too. PepsiCo managers' bonuses are tied closely to performance. Smith's name sometimes is mentioned as a contender for PepsiCo's highest posts. And industry rumors say that if Smith proves himself with Pizza Hut, PepsiCo might acquire another fast-food chain—Wendy's often is mentioned—for him to run. PepsiCo's chairman, Kendall, responds to such rumors by saying, "There's no point in adding new ones until you've got the one you own under control."

Source: "Pizza Hut's New Sales Strategy: Faster Service, Expanded Menus," *The Wall Street Journal,* November 20, 1980, p. 29.

dependence, commitment to past strategy, organizational power and politics, timing and competitive reaction may exert considerable influence on strategic choice. The next section looks in more detail at the nature of strategic choice.

Strategic choice

Strategic choice is a decision. Applicable to both corporate-level and business-level strategy, this decision is the determination of the future strategy of the firm.

Strategic choice follows the evaluation of alternative strategies. It is a decision to adopt one of these alternatives. If the evaluation process has identified a clearly superior strategy, or if the current strategy will clearly meet future company objectives, then the decision is relatively simple. Such clarity is the exception however, making the decision a judgmental and difficult task. Strategic decision makers, after comprehensive strategy evaluation, are often confronted with several viable alternatives rather than the luxury of a clear-cut, obvious choice. Under these circumstances, several factors exert influence on the strategic choice decision. Some of the more important factors are:

1. Familiarity and commitment to past strategy.
2. Degree of the firm's external dependence.
3. Attitudes toward risk.
4. Internal political considerations and the CEO.
5. Timing.
6. Competitive reaction.

Role of past strategy

A review of past strategy is the beginning point of strategy evaluation and choice. As such, it often exerts considerable influence upon the final strategic choice.

Current strategists are often the architects of past enterprise strategies. Having invested substantial time, resources, and personal commitment to these strategies, it is quite logical that the strategist would be more comfortable with a strategic choice that closely parallels past strategy or represents only incremental alterations in that strategy.

The momentum of this familiarity and commitment to past strategy permeates the organization. Thus, lower management reinforces the top manager's inclination toward continuity with past strategy during the process of strategic choice. Research by Henry Mintzberg and Barry Staw confirms the influence of past strategy on later strategic choice. Even as the strategy begins to fail due to changing conditions, they found that strategists often

increase their commitment to the past strategy.[5] This may be one reason why firms replace key executives when performance has been inadequate for an extended time period. Replacing top executives lessens the influence of unsuccessful past strategy upon future strategic choice.

Degree of the firm's external dependence

The basic purpose of a comprehensive strategy is to effectively guide a firm's performance within a larger external environment. Owners, suppliers, customers, government, competitors, and unions are a few of the elements of a firm's external environment elaborated upon in Chapter 5. A major constraint on the strategic choice decision is the power of environmental elements to support or withhold support of this decision. When a firm is highly dependent on one or more of these environmental factors, the firm's strategic alternatives and ultimate choice must carefully accommodate this dependence. The higher a firm's external dependence, the lower its range and flexibility in strategic choice.

For many years, Whirlpool sold a majority of its major appliance output to one customer, Sears. With its massive retail coverage and access to alternate suppliers, Sears presented a major external dependence for Whirlpool. Whirlpool's strategic alternatives and ultimate choice of strategy were limited and strongly influenced by the demands of Sears. Whirlpool's grand strategy, and important related decisions in areas such as research and development, pricing, distribution, and product design were carefully narrowed and chosen with the firm's critical dependence on Sears in mind. Chrysler Corporation's dependence upon federal loan guarantees and labor union financial concessions considerably limited the strategic choices available to Chrysler management for the 1980s.

These two examples illustrate that flexibility in strategic choice is lessened when the firm experiences increased environmental dependence. Where external dependence is extremely critical, firms may incorporate representatives of the external factor (government, union, supplier, bank) into the strategic choice process. Chrysler, for example, took the unprecedented action in 1979 of including Leonard Woodcock, the president of the United Auto Workers, as a regular member of the Chrysler board of directors.

Attitudes toward risk

Managers' attitudes toward risk exert considerable influence upon the strategic choice decision. Managerial attitudes toward risk vary from eager

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[5] Henry Mintzberg, "Research on Strategy Making," *Proceedings Academy of Management,* 1972. Barry Staw, "Knee-Deep in the Big Muddy: A Study of Escalating Commitment to a Chosen Course of Action," *Organizational Behavior and Human Performance,* June 1976, pp. 27–44.

risk taking to strong aversion to risk. Risk propensity influences the range of alternatives available during strategic choice. Where attitudes are favorable toward risk, the range and diversity of strategic choices expand. High-risk strategies are acceptable and desirable. Where management is risk-averse, the diversity of strategic choices is limited. Risky alternatives are eliminated before strategic choice begins. Risk-oriented managers prefer offensive, opportunistic strategies. Risk-averting managers prefer defensive, safe strategies. The influence of past strategy is quite strong in the strategic choice decison of risk-averse managers. Its influence is less of a factor in risk-oriented managers' strategic choice decisions. Figure 8–10 illustrates the relationship between attitudes toward risk and strategic choice.

Industry volatility exerts an influence on managerial risk propensity. In highly volatile industries, top managers must absorb and operate with greater amounts of risk than their counterparts in stable industries. Therefore, managers in volatile industries consider a broader, diverse range of strategies in the strategic choice decision.

Product/market evolution is another determinant of managerial risk propensity. If a firm is positioned in the early stages of product/market evolution, it must operate within a risk milieu considerably greater than that experienced late in product/market evolution.

In the strategic choice decision, risk-oriented managers lean toward opportunistic strategies with higher payoffs. They are drawn to offensive strategies that are based upon innovation, company strengths, and operating potential. Risk-averse managers lean toward safe, conservative strategies

figure 8–10
Managerial risk propensity and strategic choice decisions

Risk averse		*Risk prone*
Decrease choices	←→	Expand choices
Defensive strategies	←→	Offensive strategies
Stability	←→	Growth
Incremental	←→	Innovation
Minimize company weaknesses	←→	Maximize company strengths
Strong ties to past strategy	←→	Fewer ties to past strategy
Stable industry	←→	Volatile industry
Maturing product/market evolution	←→	Early product/market evolution

with reasonable, highly probable returns. They are drawn to defensive strategies that seek to minimize the firm's weaknesses, external threats, and the uncertainty associated with innovation-based strategies.

In summary, risk orientation influences strategic choice by narrowing or expanding choices and highlighting specific ones in the final strategic choice decision.

Internal political considerations

Power/political factors influence the strategic choice decision. The existence and use of power to further individual or group interests is a common aspect of organizational life. An early study by Ross Stagner found that strategic decisions in business organizations were frequently settled by power rather than by analytical maximization procedures, according to the business executives surveyed.[6]

A major source of power in most organizations is the chief executive officer (CEO). In smaller enterprises, the CEO is consistently the dominant force in the strategic choice decision. This is often true in large firms, particularly with a strong or dominant CEO. When the CEO begins to favor one particular choice, it often becomes the unanimous strategy selected in strategic choice decision.

Cyert and March identified another power source that influences the strategic choice decision, particularly in larger firms.[7] They called this the coalition phenonemon. In large organizations, subunits and individuals (particularly key managers) have reason to support some alternatives and oppose others. Mutual interest often draws certain groups together in coalitions to enhance their position in organization-wide issues. These coalitions, particularly the more powerful ones (often called dominant coalitions), exert considerable influence over the strategic choice decision. Studies by Mintzberg et al. and Guth confirm the use of power and coalitions on a frequent basis in strategic decision making.[8] Interestingly, Mintzberg et al. found that managers occasionally try to hide the fact that they prefer judgmental/political bargaining over systematic analysis and that when politics was a factor, it slowed the decision-making process.

Timing considerations

The time element can exert considerable influence upon the strategic choice decision. Consider the case of Mech-Tran, a small manufacturer of fiberglass

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[6] Ross Stagner, "Corporate Decision Making," *Journal of Applied Psychology* 53, no. 1 (February 1969): 1–13.

[7] Richard M. Cyert and James G. March, *A Behavioral Theory of the Firm,* (Englewood Cliffs, N.J.: Prentice Hall, 1963).

[8] Henry Mintzberg et al., "The Structure of Unstructured Decision Process," *Administrative Science Quarterly,* (June 1976), pp. 246–75; and William Guth, "Toward a Social System Theory of Corporate Strategy," *Journal of Business,* (July 1976), pp. 374–88.

piping that found itself in financial difficulty in early 1979. At the same time it was seeking a loan guarantee through the Small Business Administration (SBA), it was approached by KOCH Industries (a Kansas City based supplier of oil field supplies) with a merger offer. The merger offer required 100 percent sale of Mech-Tran stock and a two-week response deadline. The SBA loan procedure could extend three months. Obviously, the strategic decision by Mech-Tran management was heavily influenced by outsider-imposed time constraints. This limited thorough analysis and evaluation. Research by Peter Wright indicates that under such a time constraint, managers put greater weight on negative information (than positive information) and prefer defensive strategies.[9] In the case of Mech-Tran, the owners decided to accept the KOCH offer rather than risk losing this opportunity and subsequently being turned down by SBA. Faced with timing constraints, Mech-Tran management opted for a defensive strategy consistent with the findings of Peter Wright's research.

There is another side of the time issue—the timing of a strategic decision. What would otherwise be a good strategy may be disastrous if undertaken at the wrong time. Winnebago was the darling of Wall Street in 1970, its stock rising from \$3 to \$44 per share in one year. Winnebago's 1972 strategic choice, focusing on increasing its large, centralized production facility, was a continuation of the strategy that had successfully differentiated Winnebago in the recreational vehicle industry. The 1973 Arab oil embargo and the subsequent rise in gasoline prices and overall transportation cost brought dismal results for Winnebago. The strategy was good, but the timing proved disastrous.

Another important influence of timing on the strategic choice decision is related to product/market evolution. Functional skills and resource requirements associated with a firm's performance vary according to the stage of product/market evolution. Thus the timing of alternative choices relative to the stage of product/market evolution should be an important consideration in the strategic choice decision.

A final aspect of the time dimension is the lead time required by alternative choices and the time horizon management is currently contemplating. Management's primary attention may be short run or long run depending upon the firm's current circumstances. Logically, the strategic choice decision will be strongly influenced by the match between management's current time horizon and the lead time (or payoff time) associated with alternative choices.

Competitive reaction

Top management, in weighing strategic choices, frequently incorporates their perceptions of likely competitor reactions to different strategy options.

[9] Peter Wright, "The Harrassed Decision Maker," *Journal of Applied Psychology* 59, no. 5 (1974): 555–61.

If top management chooses an aggressive strategy that directly challenges a key competitor, that competitor can be expected to mount an aggressive counterstrategy. The top management of the initiating firm must consider such reactions, the capacity of the competitor to react, and the probable impact on the chosen strategy's success.

The beer industry provides a good illustration. In the early 1970s, Anheuser Busch dominated the industry. Miller Brewing Company, recently acquired by Phillip Morris, was a weak and declining industry competitor. Miller management, contemplating alternative strategies, made the decision to adopt an expensive, advertising-oriented strategy. While this strategy challenged the big three (Anheuser Busch, Pabst, and Schlitz) head on, Miller anticipated a delayed reaction due to its current declining status in the industry. Miller proved correct, and was able to reverse its trend in market share before Anheuser Busch countered with an equally intense advertising strategy.

Miller management took another approach in their next major strategic decision. In the mid-1970s, they introduced (and heavily advertised) a low-calorie beer—Miller Lite. Low-calorie beer had been tried previously by other industry members without much success. Miller chose a strategy that did not directly challenge key competitors and, Miller anticipated, would not elicit immediate and strong counterattacks. This choice proved highly successful, because Miller was able to establish a dominant share of the low-calorie market before major competitors decided to react. In both cases, Miller's expectation of competitor reaction was a key determinant in the strategic choice decision.

Contingency approach to strategic choice

The ultimate decision among a set of strategic choices often depends upon the current acceptability of various assumptions (about future conditions) on which alternative choices are based. The success of the chosen strategy is contingent, to varying degrees, upon the existence of future conditions which may change. This is fine except when changes in the industry and environment differ from underlying forecast and assumptions.

For example, Winnebago's 1972 strategy of centralized, economy-of-scale production and heavy inventory of large recreational vehicles (RVs) was contingent upon a continued supply of plentiful inexpensive gasoline for future customer use. With the 1973 Arab oil embargo, this contingency changed dramatically. Winnebago was left with extensive inventories of large RVs and high breakeven-oriented production facilities for large RVs. As a result, Winnebago is still trying to recover.

To enhance their ability to cope with similar occurrences, an increasing number of firms are adopting a contingency approach to strategic choice. In this approach, the firm identifies critical assumptions on which the success of the chosen strategy is dependent. Secondly, it identifies alternative conditions (different from the basic forecast or assumptions) that may occur in

these critical contingencies, particularly negative ones.[10] A downturn in the economy, a labor strike, an increase in the prime rate, a technological breakthrough, or a shortage of critical material are examples of such contingencies. Once these alternative scenarios are identified, the firm's managers develop alternative (contingent) strategies to which the firm can shift if one of the less probable scenarios occurs. Such contingency strategies can be short and/or long term and are appropriate at corporate-, business- and/or functional-level strategies. Firms that use this contingency approach often identify trigger points that alert management to seriously consider a contingency strategy. The trigger points are often specific conditions in industry or environmental contingencies (like the supply and price of gasoline) and are set to allow sufficient lead time for the implementation of the contingency response.

Summary

This chapter has presented and examined several considerations regarding strategy evaluation and choice in business firms. The formality of strategy evaluation varies considerably according to the stage of development of the firm. The focus of strategy evaluation differs from corporate- to business-level strategy.

In multi-industry firms and multi-product/market firms, strategy evaluation begins at the corporate level. Alternative corporate strategies are evaluated in the context of the generation and allocation of corporate resources. The portfolio approach offers one approach to the strategy evaluation task at the corporate level. The portfolio matrix and stage of product/market evolution are conceptual tools guiding the portfolio approach.

Strategy evaluation does not end with corporate-level strategy. Alternative business-level strategies must be evaluated within each business unit of multi-industry firms, much the same as strategy evaluation in single product/service firms. Key components of business-level strategy evaluation are the industry analysis and company profile. Conditions, determinants of success, and trends in the industry are matched with internal evaluation of the firm's competencies to narrow and evaluate alternative business strategies.

Evaluation often narrows alternatives to several viable choices. Strategic choice is seldom the luxury of accepting an obvious choice. Nonetheless, a choice must be made. Several factors influence strategic choice, such as risk propensity, past strategy, and coalitions, which are outside the realm of purely analytical consideration. Some firms are attempting a contingency approach to strategic choice whereby flexibility to alter a chosen strategy, if

[10] Alternative conditions of a positive as well as a negative nature should be considered. If unusually positive circumstances develop, the firm may not be in a position to exploit such favorable circumstances. However, most firms are primarily concerned with negative deviation in key contingencies.

underlying assumptions change, is incorporated into the strategic choice process.

Once corporate- and business-level strategies have been chosen, the strategic management process is not complete. Functional strategies must be identified and implemented to initiate and control daily business activities consistent with business strategy. The next chapter examines functional strategy.

Questions for discussion

1. How is strategy evaluation at the corporate level different from strategy evaluation at the business level? How are they related?
2. Why would multi-industry companies find the portfolio approach to strategy evaluation a useful one?
3. Explain the role of the stages of product/market evolution as a tool for business strategy evaluation. How is it similar/dissimilar to the product life-cycle concept?
4. What role does creativity play in the development and evaluation of alternative strategies? Please explain.
5. Past strategies are the beginning point of strategy evaluation and strategic choice. Does the material in this chapter support or refute this statement? Please explain.
6. Explain and illustrate the role managerial attitudes can play in strategy evaluation and choice.
7. Describe the matching process for business strategy evaluation. Select an industry and a firm within that industry to illustrate your discussion.

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chapter 8 cohesion case

Strategy evaluation and choice at Holiday Inns, Inc.

Before evaluating alternatives and choosing a strategy for the 1980s at Holiday Inns, Inc., let's take a few minutes to review what you have done in the Cohesion Case sections up to this point. First, you have examined company mission. An essential issue that surfaced was whether Holiday Inns is in the travel business, hospitality business, or some broader combination of the two. It seems Holiday Inn executives have traditionally used the travel definition, although the mission must be readdressed as you evaluate and choose a strategy. Second, you have examined the present and projected environment that Holiday Inns must operate within, as well as analyzing the internal strengths and weaknesses of Holiday Inns at the corporate and business group levels. Comparing these external and internal analyses provides a key basis for generating, evaluating, and choosing corporate- and business- level strategies. Finally, you have looked at different types of grand strategies that appear to be possible alternative strategies within each business group. Now you must look at the realistic alternative strategies for Holiday Inns, evaluate these alternatives, and choose the strategy that will lead Holiday Inns into the 1980s.

Numerous alternatives, particularly when you consider the permutations relative to each business group, could be generated for subsequent evaluation. To illustrate Chapter 8, we will present a limited range of strategy alternatives, taken from those identified in Chapter 7's Cohesion Case, for subsequent evaluation and choice. You are encouraged to generate additional alternatives, and then evaluate them both in and out of class.

We will look first at a limited range of alternative strategies within each of Holiday Inns' business groups (see Exhibits 1–4). This set of alternative

business strategies will then be used to generate a limited range of alternative corporate-level strategies. In presenting each alternative, we will provide a brief evaluation to both illustrate the evaluation of strategy and provide a basis for strategic choice.

With the evaluation of each business group's alternative strategies com-

exhibit 1
Hotel group

Strategy alternatives	*Strategy evaluation*
1. Pursue rapid growth through domestic and international expansion while seeking to become increasingly price competitive with quality budget chains. (Market development and joint-venture franchising)	Hotels are HI's core business, the major profit contributor, and where its greatest distinctive competencies exist. Rapid growth can only be achieved by taking on the lower-priced competitors since available locations are limited. But with markets maturing, and either increased financing or dependence on franchisees that would be required, this alternative is risky.
2. Selective growth with company-owned movement into multiuser oriented properties (resorts, airports, downtown) and gradual franchise expansion while maintaining the traditional upper-medium focus in price with high-quality service. (Concentration and Joint-venture franchising)	Consistent with changing travel patterns and shorter vacation durations for business and family travelers. Allows company-owned positioning in the more lucrative markets. Maintains favorable profit margins and positive cash generator role for corporate activity. Risks continual threat to hotel care from quality budget chains, especially for the broad franchise base.

exhibit 2
Products group (PG)

Strategy alternatives	*Strategy evaluation*
1. Aggressive expansion into new markets for institutional furnishings and equipment to lessen dependence of HI network and gain pricing autonomy. (Market development)	Not clear that the PG has the experience and competitive edge to compete in an open market basis. Would necessitate greater autonomy in pricing, product designs, and so on from the hotel group.
2. Stable growth continuing with the current operational makeup. (Concentration)	The PG has evolved into a large operation, primarily as an ancillary service to the hotel care. Its organization, mission, and strategy are not competitively derived. May have gotten too big to continue as an afterthought, given its low contribution to corporate earnings.
3. Retrench to streamline operations as strictly an institution service to the hotel group. (Concentration/retrenchment)	There is a large institutional market which the PG would be ignoring with this strategy. However, this could clarify the exact role of the PG, as strictly an ancillary service, and provide better structure for its future operating decisions.

exhibit 3
Transportation group

Strategy alternatives	*Strategy evaluation: Trailways*
Trailways: 1. Steady growth by expanding primary market share through price competition, improved image, better terminals, and linking with motel network. (Retrenchment/turnaround)	Transportation market is quite competitive, with Greyhound as well as deregulating airline industry. Could increase ridership, but lowering prices in face of rising energy costs would threaten their profit margins. Questionable whether Trailways' ridership is compatible with HI guest profile.
2. Divestiture of the Trailways bus operation. (Divestiture)	Possibly extreme and even detrimental since the bus operation has contributed steadily growing revenue at approximately 23 percent of corporate revenue since 1974. However, profitability has steadily declined and the bus operation is not compatible with all other groups in terms of customer profile. Managerial and financial resources might be better elsewhere.
Delta Steamship: 1. Steady growth in new LASH cargo services seeking to exploit and expand market share in South American routes. (Concentration/market development)	Delta has competitive start with LASH technology and a strong South American/West African route structure. Ships provide useful tax shelter and government subsidies against foreign competition. Cargo emphasis, however, is getting way outside.
2. Divestiture of Delta Steamship (Typical strategy consideration that would be introduced at the corporate level)	1978s drastic improvement in sales and profits make Delta quite marketable. Steamship cargo and passenger services are increasingly removed from HI's core competencies, suggesting divestiture. But, as of now, an increasingly profitable unit to harvest until the right buyer appears.

plete, a choice must be made. To ensure the business-level choices are consistent, choice must be made at the corporate level and then finalized at each business level.

The critical issue at the corporate level for Holiday Inns, Inc. returns back to its overall mission. Which of the following does it see as its mission?

1. Diversified firm in the travel- and transportation-related industries.
2. Diversified firm in the travel-related industry.
3. Diversified firm in the hospitality industry.

Clearly, Holiday Inns' current business portfolio would align itself with the first mission statement. However, Holiday Inns has traditionally perceived itself within mission statement 2. Its corporate-wide expertise and distinctive competence are strongest relative to statement 3. So to choose a strategy, Holiday Inns, Inc., must also clarify its overall mission.

exhibit 4
Other groups: Restaurants and casinos

Strategy alternatives	*Strategy evaluation: Restaurants*
Restaurants:	
1. Rapid expansion into freestanding restaurant business through additional acquisition as well as geographic expansion with Perkins franchises. (Market development/joint-venture franchising, and horizontal integration)	A growing primary market, but strong competition nationwide. Organizational capacity of HI to absorb and manage rapid acquisition of additional regional chains is doubtful. Risk of a market shakeout with heavy level of competition is a real possibility.
2. Concentration and steady growth via the Perkins chain above. (Concentration and joint-venture franchising)	Perkins provides an established, competitive base and competent management to guide its stable growth, backed as necessary by corporate resources. Allows HI to evaluate this new operating area before making additional acquisition or resource commitments.
Casinos:	
1. Rapid expansion into the four major U.S. areas for legalized gambling via direct investment and particularly joint ventures or acquisition. (Horizontal integration/joint ventures)	A rapidly expanding market that offers exceptional profit potential. A logical extension of HI's lodging and restaurant expertise, particularly when matched with another firm's gaming expertise. With limited U.S. areas having legalized gambling, should move rapidly to secure a foothold in each area. Offers a natural international spin-off and ultimate lessening of corporate dependence on roadside travel accommodations and franchisees.
2. Stabilize with current endeavors into gaming and only gradually commit further resources. (Joint-venture holding pattern)	Lets HI make sure gaming is an area it should be in before committing sizable resources. However, with limited areas available, could fall behind competition or newcomers (like Ramada Inns) in gaining an established foothold.

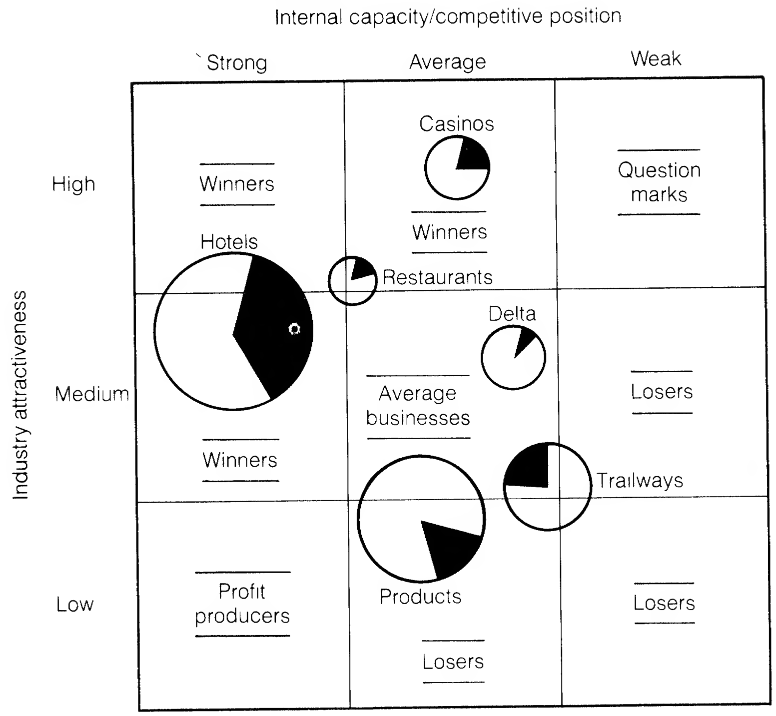
To illustrate corporate-level strategic choice, we have placed HI businesses on a business portfolio matrix in Exhibit 5. This matrix provides several insights regarding corporate-level strategy evaluation and choice.

HI's strongest position is in the hospitality-related area, with hotels providing stable growth and strong cash flow; while casinos and, to a lesser extent, Perkins restaurants represent key areas for corporate growth.

Institutional products and busline operations are the weakest portfolio members, with Trailways of questionable long-term value to the firm. The products group is of questionable value in other than a captive service role to the hotel (and other food and lodging) groups.

Delta provides a steadily profitable business, though lacking the future potential of the hospitality group and clearly unrelated to that group.

exhibit 5
Holiday Inns' business portfolio



The portfolio matrix suggests two basic corporate strategy choices for Holiday Inns, Inc.

1. Stabilize and improve the current business portfolio.
2. Concentrate on the hospitality part of the portfolio with targeted growth emphasis (particularly) in casinos.

The choice is related to the need to clarify the company mission mentioned earlier, so that two decisions must be made: clarification of mission and choice of corporate strategy. These decisions, in turn, will set the parameters for business-level strategic choices.

What should the choice be? The choice of Holiday Inns' management in 1979 is presented below. You are encouraged to read the Holiday Inns, Inc. (B) case in the case section of this book for a more detailed discussion of the factors leading to this choice.

Company mission and corporate strategy: "Our strategy for the coming decade will be to grow consistently from our leadership base in *the hospitality industry* seeking major positions in the closely related fields of hotels, casino gaming, and restaurants."

Business group strategies:

Hotel group—2 discussed earlier (concentration with selective company-owned growth).

Products group—3 discussed earlier (retrenchment and pruning).

Trailways—2 discussed earlier (divestiture with $15 million loss).

Delta—combination of 1 and 2 discussed earlier (continued cargo service expansion until profitable divestiture can be made).

Restaurants—2 discussed earlier (concentrated, steady growth at Perkins).

Casinos—1 discussed earlier (rapid growth into four major regions).

And the long-term objectives associated with the corporate strategy are as follows.

"The primary goal of HI management is to maximize the value of HI stock to its shareholders."

Dividend payout of 25–30 percent of normalized earnings.

Maintain a debt/capital ratio under 50 percent.

Return on equity to exceed 17 percent annually.

Develop a favorable climate for the company in the communities in which it conducts its business through corporate philanthrophy programs with annual goals ($1.25 million in 1979).

part three

Strategy implementation

IN this last part of the text we turn your attention to what is often called the action phase of the strategic management process: the implementation of the chosen strategy. Up to this point you have covered three major phases of the strategic management process: strategy formulation, evaluation of alternative strategies, and strategic choice. While these are important, they alone cannot ensure success. The strategy must be translated into concrete action and that action must be carefully implemented. If this is not done, then accomplishment is left to chance.

Two chapters are provided in this implementation section to examine the *action phase* of strategic management.

Chapter 9 examines the role of functional strategies and annual objectives as the starting point of strategy implementation. Functional strategies

operationalize business-level strategy by translating the conceptual strategy into concrete action guides for the businesses' operating managers. As such, functional strategies provide a critical link between formulation and implementation. And as detailed guides to action in marketing, finance, operations, R&D, and personnel, functional strategies provide a final *test of consistency* for the business-level strategy.

Chapter 10 examines key managerial tools that are commonly used to implement a strategy. Besides functional strategies, this chapter looks at organizational structure, leadership considerations, budgets, schedules, and reward systems as key tools in strategy implementation and control. It concludes with an explanation of strategic control: the long-term review and assessment of the strategy's impact as a feedback mechanism for adjusting or changing corporate strategy.

chapter 9

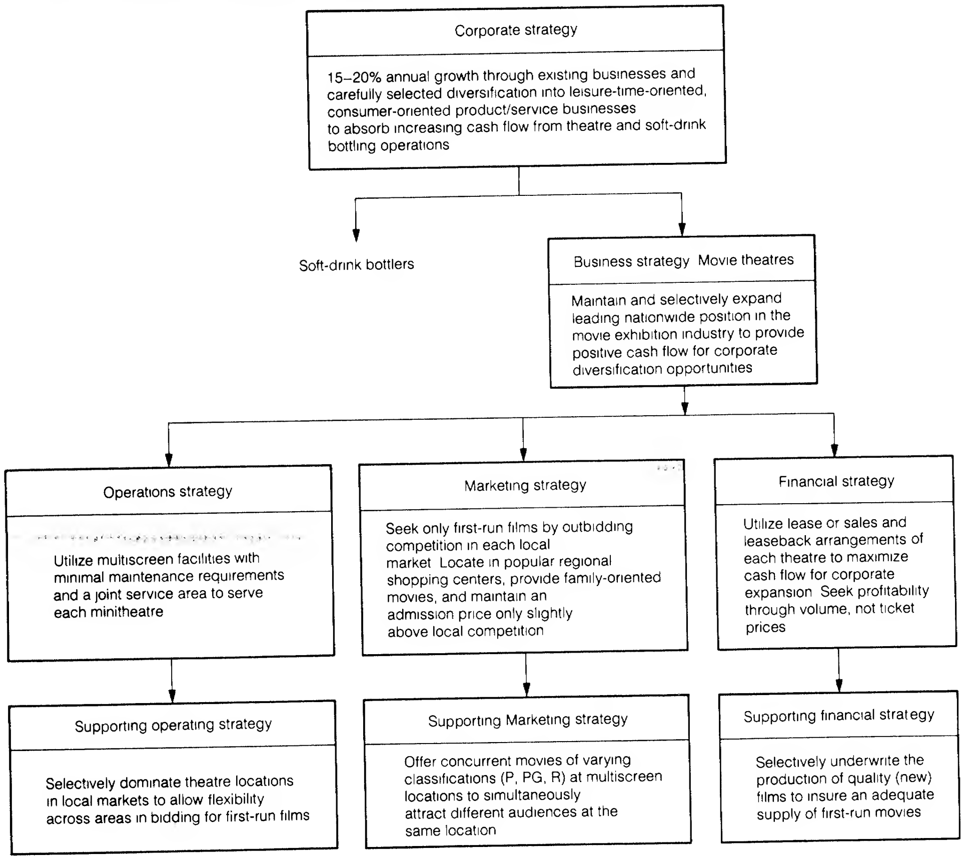
Functional strategies and annual objectives

EVEN after the corporate- and business-level strategies are determined, the strategic management process is far from complete. The tasks of implementation, monitoring, and control still remain. These signal a critical phase in the strategic management process: translating strategic thought into strategic action. The first step in this action phase is the identification of functional strategies and annual objectives.

Strategies must be formulated and implemented in the key functional areas of marketing, finance, production/operations, R&D, and personnel consistent with business objectives and strategy. Functional strategies operationalize business strategy by organizing and activating specific means (marketing, finance, production, and so forth) to pursue the business strategy in daily business activity. In a sense, functional strategies translate thought (business strategy) into action. Functional strategies identify and coordinate actions to be taken in marketing, finance, R&D, production, and personnel that support the business strategy and enhance the likelihood of accomplishing the goals of the firm.

Figure 9–1 illustrates the importance of functional strategies in operationalizing corporate- and business-level strategy. The corporate strategy defined the company's (General Cinema Corporation) general posture in the broad economy. The business strategy outlines the competitive posture of its movie exhibition operations within the domestic (U.S.) market. But to enhance the likelihood that these strategies will be successful, more specific guidelines are needed for the business's functional components. Thus, functional strategies are derived that operationalize the business strategy, giving specific, short-term guidance to the operating managers of the firm. The General Cinema example in Figure 9–1 illustrates possible functional strategies in the functional areas of operations, marketing, and finance. Other functional strategies would be necessary, most notably the personnel area. The functional strategies offered in Figure 9–1 are provided to illustrate the logical flow from corporate strategy to functional strategy and the differences between the levels of strategy.

figure 9-1
Role of functional strategies at General Cinema Corporation



Differences between levels of strategy

Up to this point, we have focused primarily upon corporate strategy and business strategy. To better understand the role of functional strategies within the strategic management process, it is useful to understand how they differ from corporate and business strategies. Functional strategies differ from corporate and business strategies on at least three basic characteristics:

1. Time horizon covered by the strategy.
2. Specificity of the strategy.
3. Participants in the strategy's development.

The time horizon under consideration in functional strategy is usually shorter than the time horizon associated with business or corporate strategy. Functional strategies identify and coordinate short-term actions, usually within a year or less. Sears, for example, might choose a marketing strategy

of increased price discounts and sales bonuses in its appliance division to reduce excess appliance inventory over the next year. This short-range marketing strategy would be a temporary component of the business-level strategy which might focus on Sears' position in the appliance industry over the next five years.

Functional strategy is more specific than business strategy. Functional strategy guides actions to be taken in key functional areas in order to implement the business strategy. Returning to the Sears example, the business strategy of Sears' appliance division is to offer competitively priced home appliances to the middle-income consumer, who relies on Sears' reputation and service capabilities. Functional strategies would include its pricing policy, advertising media and expenditure, the specifics of its purchasing schedule from suppliers, and the distribution logistics within the Sears network. The business strategy provides general direction. The functional strategies provide specific actions to be taken consistent with the general direction of the business strategy.

Participants in strategy development are another dimension on which functional and business strategies differ. Business strategy is primarily the domain of top management in the organization. Functional strategy incorporates more active middle management input into its development. The business strategy of Sears' appliance division is developed by the senior management of that division in conjunction with Sears' corporate-level executives. The development of functional strategies within the appliance division will incorporate regional executives of that division. In addition, Sears incorporates the participation of local store executives in the determination of selected functional strategies (like marketing) under certain conditions.

While the three levels of strategy have different characteristics, they are critically interdependent. Accomplishment of corporate strategy depends upon successful business strategy which, in turn, depends upon integrated functional strategies. Although each level of strategy focuses upon different internal and/or external dimensions, there is a critical overlap (interdependence) in the focus of each level of strategy. The critical overlap between business strategy and functional strategies helps to generate coordination among functional area strategies. The success of the business strategy is predicated upon functional strategies that are compatible and mutually reinforcing.

Development of functional strategies

The development of functional strategies involves two processes: (1) formulation of the basic strategy in each functional area and (2) the deployment of resources to support these strategies. Before examining these processes in more detail, an important point about the nature of the discussion is in order. To facilitate understanding, the factors influencing the development of functional strategies have been conceptually segmented for discussion purposes.

In practice, the formulation of functional strategies and resource deployment decisions are iterative and inextricably interwoven with each other and business strategy development. The formulation of different levels of strategy is not a neat, sequential process in most business firms. With this caveat in mind, an examination of the formulation of functional strategies is now appropriate.

Formulation of functional strategies

Functional area strategies must be formulated so that they give specific guidance to operational managers. These strategies provide decisional guides to operational managers' actions and seek to ensure that they know what they are supposed to do. It is not enough to identify a generalized grand strategy at the business level. Functional area strategies must outline what should be done in each functional area if the long-term objectives of the business strategy are to be achieved. Specific functional strategies enhance operating managers' willingness (and ability) to implement strategic decisions, particularly when that decision represents a major change in the current strategy of the firm.

Consider, for example, the case of a small ($60 million in sales), once-profitable maker of industrial plastics. One year after being acquired by a large conglomerate, it suffered a serious downtown and was performing well below the corporate target return on investment (ROI). Rather alarmed, corporate management decided to institute a formal strategy development effort at the firm. Figure 9–2 presents the results of this effort, delineating five alternative business strategies with selected functional strategies associated with each grand strategy.[1]

Figure 9–2 illustrates the critical importance of functional strategies in several ways. First, assume their strategy development process had stopped after identifying (and choosing) a grand strategy. The ability of the respective functional managers to implement the chosen strategy would be seriously curtailed by the absence of the specific guidelines (functional strategies) that comprise the major portion of Figure 9–2. Second, success of the grand strategy requires the coordination and integration of functional efforts. Developing functional strategies as shown in Figure 9–2 highlights functional interdependence and should enhance coordination across functional areas. Finally, the differences in alternative grand strategies do not appear too great across any two adjacent ones (in Figure 9–2). But when translated into specific functional strategies, the differences become quite apparent—illustrating the critical role of functional strategies in ensuring that grand strategies are properly operationalized.

[1] The figure includes a general description of functional strategies as well as selected aspects of functional strategies in marketing, production, and finance.

Generalizing about the formulation of strategies across functional areas is difficult. For example, key variables in marketing are different from finance or production. Furthermore, within each functional area, the critical importance of key variables varies across different business situations. The next several sections do not exhaustively treat the functional areas. Rather, they attempt to illustrate key decision variables that should be addressed in formulating functional area strategy.

Formulating functional strategy: Marketing

The role of the marketing function is to profitably bring about the sale of products/services to target markets for the purpose of achieving the business's goals. Marketing strategy should provide decisional guides to this endeavor in a manner consistent with the business strategy and other functional strategies. An effective marketing strategy should guide the marketing managers in determining who will sell what, where, when, to whom, in what quantity, and how it will be sold. In order to do this, marketing strategy must address four strategic components: product, price, place, and promotion. Figure 9–3 provides a brief reference to the decision areas covered by these four strategic components.

The product component of marketing strategy clearly identifies the customer need the firm seeks to meet with its product and/or service. A clear statement of the product/service component should guide marketing managers' decisions regarding features, product lines, packaging, accessories, warranty, quality, and new product development. This component provides a comprehensive statement of the product/service concept and the target market(s) it is seeking to serve. This in turn fosters consistency and continuity in the daily activity of the marketing function.

A product or service is not much good to a customer if it is not available when and where it is wanted. So the place component of marketing strategy identifies where, when, and by whom the product/services are to be offered for sale. The primary concern here is the channel(s) of distribution—the combination of marketing institutions through which the products/services flow to the final user. This component of marketing strategy guides decisions regarding channels, such as single versus multiple channels, seeking to ensure consistency with the total marketing strategy.

The promotion component of marketing strategy defines the manner in which the firm will communicate with the target market. The promotion component should provide basic parameters to marketing manager(s) in the use and mix of advertising, personal selling, sales promotion, and media selection. It must be consistent with other marketing strategy components and, due to cost requirements, closely integrated with financial strategy.

The price component of marketing strategy is perhaps the single most important consideration in marketing strategy. It directly influences demand

figure 9–2
Alternative business strategies

Business strategy		*General description*	*Marketing/product line strategy*	*Production/facilities requirement strategy*	*Financial/capital costs strategy*	*Timing: functional strategy implementation*
Managed exit from business (Retrenchment)	Divest	Maximize cash flow and earnings Cut back R&D, sales force, technical service Sell proprietary technology and specialty business Minimize EPA/OSHA compliance	300mm lbs of current products (declining to 225mm with loss of productivity)	Patch up Newark and Houston plants to meet minimum EPA/OSHA regulatory requirements	\$2mm–\$2.5mm (nonmaintenance EPA/OSHA expenditures)	Shut down both plants in 2½ years (by June 1979)
Think lean commodity producer (Stable growth)	Harvest	Operate as lean as possible: Reduce R&D, technical service, and sales force to minimum Sell proprietary technology and specialty business Contract 80+ percent of output Compete as a commodity rather than specialty producer	240mm lbs. product A 190 product B 430 mm lbs.	Concentrate manufacturing at Houston plant Close Newark plant by end of 1979 Finish Houston expansion and open a second line for product B production	\$14.0mm Houston expansion 5.0 Product B line 3.25 Refurbish 16th reactor from Newark \$22.25mm	Houston expansion completed mid-1977 Product B capacity completed late 1977
Think small specialty producer (Stable growth)	Selective investment	Compete only in those markets with a competitive advantage (e.g., products B and C) Develop small, specialized sales staff, technical service group, research and development team Expand specialty business on a wait-and-see basis	220mm lbs. product B 135 product C 355 mm lbs.	Convert product A expansion at Houston to product B Transfer 16th reactor at Newark to Houston on-line with five small reactors Locate specialty plant at either plant location	\$14.0mm Houston expansion 3.25 Refurbish 16th reactor 1.0 Other \$18.25mm	Product B capacity completed mid-1977 Product C capacity on-stream in late 1977

Buy-time approach (Combination)	Selective investment	Consolidate current product lines at Houston: Maintain current *potential* product mix Renew all productive capacity Operate small specialty business (25mm–30mm lbs.) at either Newark or Houston plants Selectively trim and add to sales force, technical service, R&D, other overhead departments	210mm lbs. product A 180 product B 310 product C 700mm lbs.	Locate three product lines at Houston One-line product A (two 18,000 gal. reactors) One-line product B (16th reactor plus five old reactors) New-line 25,000-gal. reactor for product C Shut down Newark plant by December 1977	$14.0mm Houston expansion 5.0 Product C line 1.25 Refurbish 16th reactor 2.0 Other $22.25mm	Houston product A capacity on-stream late 1978 Flexible plant (three lines) on-stream late 1979
Consolidate position/build a flexible three-product plant (Combination)	Selective investment	Load Houston plant with product A production Aggressively pursue specialty business at Newark plant If specialty program succeeds, expand Newark plant capacity for specialty products	At Houston: 250mm lbs. product A At Newark: 180mm lbs. product B 150 product C 330mm lbs.	Houston expansion for product A production Begin Newark two-product expansion of specialty business in mid-1977 Product B line Products C and D line	$14.0mm Houston expansion 6.0 –$7.0mm EPA/OSHA 6.0 Newark revitalization $26.0mm	250mm lbs. product A capacity at Houston available 1978 130mm–150mm lbs. expansion at Newark available 1981

Source: Adapted from Carter F. Bales, "Strategic Control: The President's Paradox," *Business Horizons*, August 1977, p. 26. Copyright, 1977, by the Foundation for the School of Business at Indiana University. Reprinted by permission.

figure 9–3
Marketing strategy components

Strategy component	*Key decision areas the component addresses*	*Typical operating questions the marketing strategy helps answer*
Product (or service)	Consumer need the product/service seeks to meet New product/service development Product/service modification or elimination Product mix	Which products do we emphasize? What is the product/service image we seek to project? Which products/services contribute most to profitability? What changes should be influencing our customer orientation?
Price	Price segments targeted (high, medium, low, etc.) Pricing policies and orientation Price setting and changing approach Cost versus demand versus competition-oriented pricing Flexibility, discounts, terms	Are we primarily competing on price? Can we offer discounts or other pricing modifications? Are pricing policies standard nationally or is there regional control? What is the gross profit margin?
Place	Channel(s) of distribution (single versus multiple) Channel objectives, structure, management Geographic location of markets Sales organization Market exposure	Is there adequate market coverage and service? Are there priority geographic areas? Should the marketing managers change their degree of reliance on distributors, sales reps, and direct selling? Is the sales force organized around territory, market, or product?
Promotion	Sales promotion philosophy and approaches Advertising/communication policies Media usage	What are the firm's advertising objectives? Which advertising/communication policies and approaches are linked to different products, markets, and territories? Which media would be most consistent with the total marketing strategy?

and supply, profitability, consumer perception, and regulatory response. The pricing strategy will take one of three approaches: cost oriented, market oriented, or competition oriented. A cost-oriented approach centers pricing decisions on the total cost of a product or service, usually in the form of acceptable markup or target price ranges. A market-oriented pricing strategy guides pricing based upon consumer demand, such as current gasoline pricing in a deregulated oil industry. Competition-oriented pricing strategy centers pricing decisions around those of the firm's competitors, such as the current discount pricing in the U.S. automobile industry. While a firm's pricing strategy may be predominated by one orientation, such as market demand, it is always influenced to some degree by the other orientations.

Figure 9–4 illustrates the four marketing strategy components for a paint manufacturing firm. The left side of the table offers the product, place,

strategy in action, 9–1
Implementing New Functional Strategies at the *Washington Star*

In early 1978, Time Inc., shelled out $20 million for the *Washington Star*. It was widely expected that its competition with the *Washington Post* would be a classic confrontation between publishing titans. However, the expected sort of titanic struggle did not occur. Set against the awesome resources of the *Post*, the changes at the *Star* seemed little more than window dressing. It appeared that Time's Washington gambit was primarily financial, one designed for a quick return on investment and not for the far more elusive editorial preeminence.

Time executives anticipated the *Star's* turn toward profitability by 1983. Considering that the paper lost approximately $16 million in 1979, that timetable was ambitious. The Time strategy for quickly reversing the *Star's* financial fortunes was to market the paper not as an alternative to but as a complement to the *Post,* both editorally and as an advertising medium. To attract readers, the *Star* began new, lighter, feature-type sections—fashions, sports, weekend, arts, and books. It also launched five local editions aimed at separate suburban areas, and a morning edition dubbed "A.M. Extra" for advertisers. *Star* executives argued that this thinner paper offered merchants more prominent displays.

After sprucing up its editorial side, the *Star* began its first drive to boast advertising and circulation by offering cut-rate ads to merchants and give-away Sunday papers to weekday subscribers, and aggressively promoting its fledging morning edition.

The *Star* made gains under Time's stewardship. By March 1979, the paper's daily circulation had increased from 329,147 to 340,150—a 3.3 percent increase in one year. Measured in ads, the Star sold 2,985,400 lines in July 1979, up 11 percent from July 1978.

Time Inc. originally expected the *Star* to be moderately profitable and a highly valuable investment in terms of capital appreciation. It would achieve those objectives if it were worth the $150 million to $200 million which was projected for the end of 1983.

Source: Based on the article "The *Washington Star*: The Rebuilding Plan is Mostly Window Dressing," from the September 24, 1979 issue of *Business Week*.

figure 9-4
Relation of marketing strategy to operational decisions for paint manufacturer

Marketing strategy components	*Associated operational decisions*
Product—Carry as limited a line of colors and sizes as will satisfy the target market.	Add, change, or drop colors and/or can sizes as customer tastes and preferences dictate.
Place—Try to obtain distribution in every conceivable retail outlet which will handle this type of paint in the areas where the target customers live or buy.	If a new retailer opens for business in these market areas, immediately solicit an order.
Promotion—Promote the low price and satisfactory quality to meet the needs of the market.	Regularly change the point-of-purchase and advertising copy to produce a fresh image. Media changes may be necessary also. Sales people have to be trained, motiviated, etc.
Price—Maintain a low one-price policy without specials or other promotional deals.	If paint companies in other markets cut prices, do not follow.

Source: Adapted from E. Jerome McCarthy, *Basic Marketing*, 7th ed. (Homewood, Ill.: Richard D. Irwin, 1981), p. 46.

promotion, and price components of the firm's marketing strategy. The right side of the table illustrates a functional manager's decision based upon the marketing strategy component associated with that decision.

Formulating functional strategy: Finance/accounting

The role of financial strategy is to direct the use of the firm's economic resources to most effectively support the business strategy and objectives of the firm. Financial strategy should provide decisional guides for financial managers consistent with the demands of other functional areas and the overall business strategy. An effective financial strategy should guide the financial manager in determining the appropriate long-term capital investment, use of debt financing, dividend allocation, and short-term asset management for the firm. In order to do this, financial strategy should address four components: capital structure, debt management, dividend management, and working capital management. Figure 9-5 provides a brief reference to the decision areas covered by these four components of financial strategy.

The capital structure component of financial strategy seeks to identify the long-term sources of financing the firm's major productive assets. The capital structure component seeks to guide decisions regarding the use of debt, preferred stock, common stock, and other financing instruments in support of capital investment requirements. The capital budgeting process is often the manifestation of the capital structure component of the firm's financial strategy.

figure 9-5
Financial strategy components

Strategy component	*Key decision areas the component addresses*
Capital structure	Long-term investment decisions Use of leverage Acceptable cost of capital Taxation Ownership/risk/flexibility
Debt management	Leveraging/leasing Level of risk Solvency/types of ownership Business cycle problems
Dividend management	Level of internal financing Uses of stock Growth rate
Working capital management	Cash flow requirements Management of current assets Credit/collection policies Inventory control Short-term investments Short-term financing

Debt strategy is a key component of financial strategy, closely interrelated with the other three components. The proper use of debt can greatly affect a firm's solvency, growth, and profitability. The debt management component of financial strategy should guide managers in the awareness of the firm's debt capacity and the use of leverage—a firm's indebtedness in relation to equity. General Cinema has successfully used debt management (leverage) to become number one in the movie exhibition and soft-drink bottling industries. Eastern Airlines was less successful, inhibiting its flexible response to competitive pressures of a deregulated airline industry due to an overleveraged position.

Dividend management is an integral component of the firm's internal financing posture. Since dividends are paid for a firm's earnings, lower dividends increase internal funds available for growth. Internal financing capability reduces the need for external, often debt, financing. However, stability of earnings and dividends often contribute positively to the market price of a firm's stock. Therefore, decisional guides regarding dividend management must be carefully considered to support the business strategy's dependence on equity markets.

Working capital requirements are critical to the daily operating success of the firm. Working capital requirements are directly influenced by seasonal and cyclical fluctuations, firm size, and the pattern of receipts and disbursements. The working capital component of financial strategy, built upon are accurate projection of cash flow, must provide cash management guidelines to ensure conserving and rebuilding cash balances as required for daily operation of the firm.

Formulating functional strategy: Research and development (R&D)

With the increasingly rapid rate of technological change in most competitive industries, R&D has assumed a key functional role within many organizations. In the technology-intense computer and pharmaceutical industries, for example, firms typically spend between 4 and 6 percent of their sales dollars on R&D work. In other industries, such as the hotel/motel industry and the construction industry, R&D spending is less than 1 percent of sales. Thus, in the technology-intense industries, R&D is a vital function—a key instrument of corporate strategy. For stable, less innovative industries, R&D plays a lesser role than do marketing, finance, and operations as critical instruments of corporate strategy.

Figure 9–6 illustrates the concerns that should be addressed in R&D strategy. First, R&D strategy should clarify the emphasis on basic research versus product development. Several major oil companies now have solar energy subsidiaries. Their R&D strategy currently emphasizes basic re-

figure 9–6
R&D strategy components

R&D decision area	*Typical issues addressed*
Basic research versus commercial development	To what extent should innovation and breakthrough research be emphasized? In relation to the emphasis on product development, refinement, and modification? What new projects are necessary to support growth?
Time horizon	Is the emphasis short term or long term? Which orientation best supports the business strategy? marketing and production strategy?
Organizational fit	Should R&D be done in-house? contracted out? Should it be centralized or decentralized? What should be the relationship between the R&D unit(s) and product managers? marketing managers? production managers?
Basic R&D posture	Should the firm maintain an offensive posture, seeking to lead innovation and development in the industry? Should the firm adapt a defensive posture, responding quickly to competitors' developments?

search, while smaller competitors are placing emphasis on product development.

Directly related to basic research-product development emphasis is the time orientation for R&D efforts mandated by R&D strategy. Should efforts be focused on the near future or the long-term future? The solar subsidiaries of the major oil companies have adopted long-term perspectives, while their smaller competitors appear to be focusing on the immediate future. These orientations are consistent with business strategy if the major oil companies seek to ensure their long-term position in the energy field and the smaller solar companies are seeking to establish a competitive niche in the growing solar industry.

R&D strategy should also give guidance to decisions regarding the organization of the R&D function. For example, should the R&D efforts be conducted solely within the firm or should portions of the R&D work be contracted outside the firm? Closely related, should R&D be a centralized or decentralized function within the organization?

Exerting influence on each of the decision areas above is the basic R&D posture of the firm. This is a critical dimension of R&D strategy. A firm's R&D strategy can have three basic postures: offensive, defensive, or combination. An offensive R&D strategy places great emphasis on technological innovation and new product development as the basis for the firm's future success. Small, high-technology firms place great emphasis on this R&D posture as a key component of their overall growth strategy. However, this orientation represents high risk (and high payoff) and demands considerable technological skill, forecasting expertise, and the ability to quickly transform basic innovations into commercial products.

A defensive R&D strategy puts greater emphasis on product modification and the ability to copy or acquire new technology in order to maintain a firm's position in the industry. American Motors (AMC) is a good example. Faced with the massive R&D budgets of General Motors, Ford, and foreign competitors, AMC has placed R&D emphasis on bolstering the product life cycle of its prime products (particularly jeeps) and acquiring small car technology through a partnership arrangement with Renault of France.

A combination offensive/defensive strategy often applies to large companies with some degree of technological leadership. GE in the electrical industry, IBM in the computer industry, and DuPont in the chemical industry all seek defensive R&D efforts regarding currently available products while heavily emphasizing an offensive R&D posture through basic, long-term research.

Formulating functional strategy: Production/operations

Production/operations management (POM) is the core function in the business firm—the process of converting inputs (raw material, supplies, people, and machines) into value-enhanced output. This function is most easily as-

sociated with manufacturing firms. However, it applies equally to all other types of business firms (service and retail, for example).

The POM strategy must guide decisions regarding: (1) the basic nature of the firm's POM system, seeking an optimum balance between investment input and production/operations output, and (2) location, facilities design, and process planning on a short-term basis. Figure 9-7 illustrates these concerns for a manufacturing business, highlighting key decision areas in which the POM strategy should provide guidance.

The plant and equipment component of POM strategy coordinates decisions regarding plant location, size, equipment replacement, and facilities utilization to be consistent with business strategy and other functional strategies. In the mobile home industry, for example, Winnebago's plant and equipment strategy has been to have one large, centralized production center (in Iowa) located near its raw materials with modernized equipment and a highly integrated production process. Fleetwood, Inc., a California-based competitor, has opted for dispersed, decentralized production facilities located near markets. Fleetwood emphasizes maximum equipment life and less integrated, labor-intensive production processes.

The production planning and control component of POM strategy provides decisional guidelines regarding the ongoing production (or operations) process. The purpose is to encourage efficient organization of production/operations resources to match long-range, overall demand. Often this component dictates whether the production/operations process will be demand oriented, smoothing oriented, or subcontracting oriented. If demand is cyclical or seasonal, then POM strategy must ensure that production/operations processes are efficiently geared to this pattern. A bathing suit manufacturer would prefer inventories at their highest in the early spring, for example, not the early fall. In a less cyclical setting, a firm might emphasize *operations smoothing,* seeking to have a steady production process and inventory level. When demand fluctuations are less predictable, many firms facilitate subcontracting in their POM strategy to handle sudden increases in demand while avoiding idle capacity and excess capital investment.

The production planning and control component as well as the labor and engineering components should provide decisional guides to POM managers on such questions as:

What is the appropriate inventory level? purchasing procedures? level of quality control?

What is the trade-off in cost versus quality emphasis in the production/operations process? What level of productivity is critical?

How far ahead should we schedule production? guarantee delivery? hire personnel?

What parameters should be followed in adding or deleting equipment, facilities, shifts, and people?

figure 9-7
Production/operations (POM) strategy decision areas for a hypothetical manufacturer

Decision area	*Decision*	*Alternatives*
Plant and equipment	Span of process	Make or buy
	Plant size	One big plant or several smaller ones
	Plant location	Locate near markets or locate near materials
	Investment decisions	Invest mainly in buildings or equipment or inventories or research
	Choice of equipment	General-purpose of special-purpose equipment
	Kind of tooling	Temporary, minimum tooling or production tooling
Production planning and control	Frequency of inventory taking	Few or many breaks in production for buffer stocks
	Inventory size	High inventory or a lower inventory
	Degree of inventory control	Control in great detail or in lesser detail
	What to control	Controls designed to minimize machine downtime or labor cost or time in process, or to maximize output of particular products or material usage
	Quality control	High reliability and quality or low costs
	Use of standards	Formal or informal or none at all
Labor and staffing	Job specialization	Highly specialized or not highly specialized
	Supervision	Technically trained first-line supervisors or nontechnically trained supervisors
	Wage system	Many job grades or few job grades; incentive wages or hourly wages
	Supervision	Close supervision or loose supervision
	Industrial engineers	Few or many industrial engineers
Product design/ engineering	Size of product line	Many customer specials or few specials or none at all
	Design stability	Frozen design or many engineering change orders
	Technological risk	Use of new processes unproved by competitors or follow-the-leader policy
	Engineering	Complete packaged design or design-as-you-go approach
	Use of manufacturing engineering	Few or many manufacturing engineers

Source: Adapted from Wickman Skinner, "Manufacturing—Missing Link in Corporate Strategy," *Harvard Business Review,* May–June 1969.

The overall POM strategy must be highly coordinated with the marketing strategy if the firm is to succeed. It also requires careful integration with financial strategy components (such as capital budgeting and investment decisions) and the personnel function of the firm.

Formulating functional strategy: Personnel

The final functional area, personnel, is a staff function within most organizations that has taken on increased strategic importance in recent years. Personnel management is concerned with aiding the accomplishment of business strategy by providing competent, well-motivated employees. Personnel strategy should provide decisional guides that encourage effective utilization of human resources to achieve both the objectives of the firm and the satisfaction and development of the employees.

Personnel strategy should operationalize the human resource needs of the business-level strategy by providing decisional guides in the areas of:

Employee recruitment, selection, and orientation.

Career development and counseling, performance evaluation, and training and development.

Compensation.

Labor relations and EEOC requirements.

Discipline, control, and evaluation.

The recruitment, selection, and orientation component of personnel strategy guides personnel management decisions in attracting and retaining motivated, productive employees. What are key human resource needs to support a chosen strategy? How do we recruit for these needs? How sophisticated should the selection process be? How should new employees be introduced to the organization? The recruitment, selection, and orientation component of personnel strategy should provide basic parameters within which to answer these questions.

The development and training component of personnel strategy should guide personnel actions taken to meet human resource needs of the future business strategy. Merrill Lynch, a major stock brokerage firm, has adopted a long-term corporate strategy of becoming a diversified, financial service institution. In addition to handling stock transactions, Merrill Lynch is actively moving into areas such as investment banking, consumer credit, and venture capital. In support of these far-reaching, long-term objectives, Merrill Lynch has incorporated extensive early-career training and ongoing career development programs to meet its expanding need for multiple-competency personnel.

Personnel strategy should provide decisional guides in the areas of compensation, labor relations, EEOC, discipline, and control to enhance the productivity and motivation of its work force. What are the standards for

promotion? How should payment, incentive plans, benefits, and seniority policies be interpreted? Should hiring preference be given? What are appropriate disciplinary steps? These are all specific personnel decisions that operating managers frequently encounter. The personnel strategy should provide clear guidance to such decisions that will enhance compatibility with the business strategy and other functional area strategies.

Integration and coordination of functional strategies

Comprehensive functional strategies are critical to the successful implementation of the business strategy. However, they can also contribute substantially to the failure of business strategy. The reason for this condition is twofold.

strategy in action, 9–2
K mart Operationalizes a New Business Strategy

Not long ago, employees in K mart discount department stores began shuffling shelves, replacing racks, moving whole departments, and blazing new aisles. When they finished, the stores had a new look, and K mart Corporation, the world's second largest retailer, had started on a new merchandising tack.

The trouble is that K mart can no longer rely entirely on its old strategy of growth through building new stores. Since the first K mart opened in 1962, offering everything from baby oil to motor oil at cut-rate prices, the stores have proliferated, turning the former S. S. Kresge Company from a so-so five-and-dime chain into the biggest retailer next to Sears, Roebuck and Co.

Now, with stores in nearly all the 300 top metropolitan areas in the country, some of which are saturated, K mart's growth through expansion is increasingly limited. The answer is to try for more volume, and more profitable volume per store, from the cost-conscious consumers attracted by K mart's low prices.

That means K mart can't risk losing its discount appeal, but at the same time it must move more and higher quality goods. To achieve those goals, K mart is relying heavily on sophisticated merchandising. The standard K mart—a cavernous building of plain design filled with racks, bins, and metal shelves—has been changed here to emphasize the merchandise at least as much as the price tags and signs. Displays of clothing and other goods are being altered to stimulate impulse buying. In addition, higher-quality goods are being offered.

strategy in action, 9-2 ***(concluded)***

A workable formula

Jeffrey B. Edelman, a securities analyst for Dean Witter Reynolds Inc., calls the effort to wring more profit out of existing stores "a long-needed step." The new generation of discount stores, he says, "are laid out differently and merchandised better than K mart stores."

K mart's main competitors, although smaller, have become more innovative in merchandising and sales techniques. "To a degree," another securities analyst says, "K mart got stuck in 1972 and hadn't changed much in the company since. They found a formula that worked, and felt they'd be fools to depart from it." Meanwhile, the competition forged ahead.

"There's going to be considerably more emphasis on improving operations," says chairman and chief executive Bernard M. Fauber, "perhaps with a shift away from store expansion."

"I'll admit, we're reacting," Fauber says. "You'd be a fool in this business not to study your competition and react." He says, however, that with the cheapest prices in town, "a K mart will still be a K mart."

K mart's heavy advertising consistently has attracted customers, especially cost-conscious middle- and upper-income customers. "But too often we fail to merchandise all of the items that customers would buy from us after we get them into the store," Fauber says. "We simply aren't getting enough of their spendable dollars."

Although the changes in K marts seem subtle, they're designed to create an atmosphere conducive to free spending. In women's apparel, rows and rows of long pipe-racks have been replaced by multilevel, circular, and honeycomb racks that allow customers to see whole garments. Higher-quality, more fashionable soft goods hang on the new racks. "Our customers won't have to suffer a polyester attack in our stores anymore," a spokesman says.

Delicatessen and snack counters have moved to a wall from their front-and-center position. Now, jewelry greets shoppers inside the entrances. "We wanted to get the popcorn out from in front of the door," says Richard H. Falck, senior vice president and treasurer. The jewelry includes higher-quality pieces and more brand-name items.

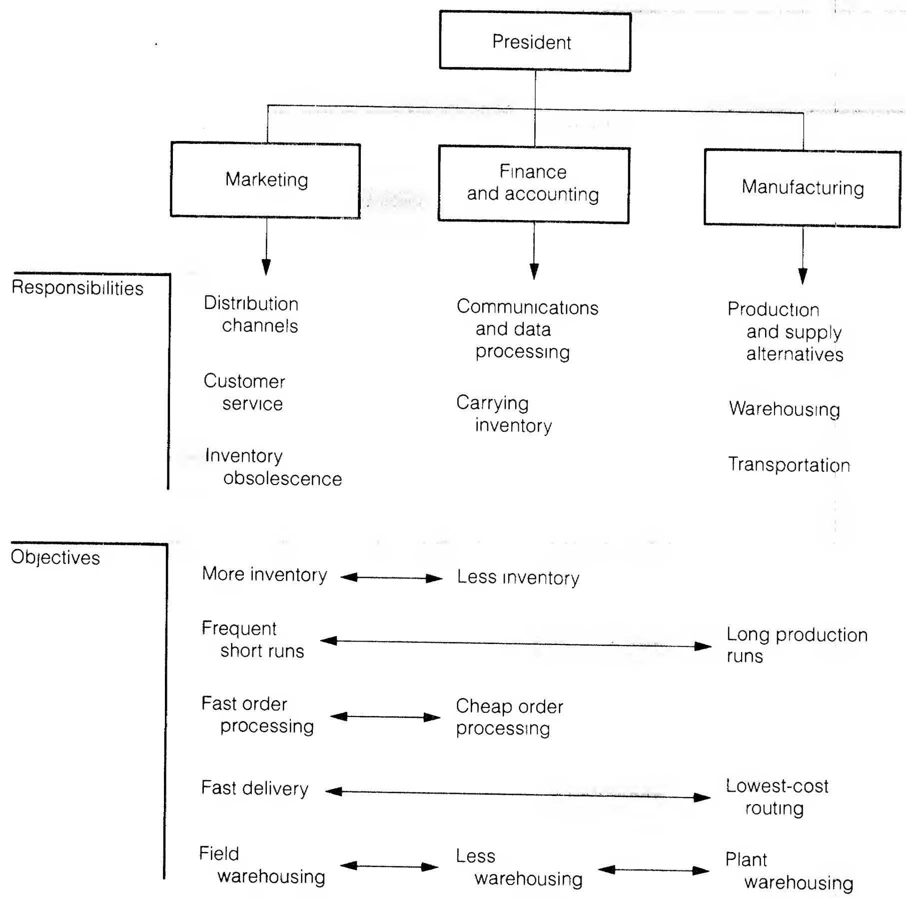
Sales of women's wear and jewelry have increased in the redesigned stores, K mart managers say.

Fauber sees his job as helping K mart mature. "K mart is somewhere between infancy and adolescence," he said to a group of securities analysts last spring. "We have a lot of physical growth ahead, but are becoming increasingly self-conscious about our looks."

Source: "K mart Stores Try New Look to Invite More Spending," *The Wall Street Journal,* November 26, 1980, p. 29.

First, the distinct nature of the responsibilities, tasks, and objectives in each functional area can lead to conflict between functional areas. Consider the simple example in Figure 9-8 of logistic priorities across three functional areas in a hypothetical manufacturing firm. The logistical priorities of the marketing function can easily conflict with those of manufacturing or finance/accounting. Manufacturing might logically prefer long production runs and plant warehousing to maximize efficiency. Marketing might be better served by frequent, short production runs and field warehousing to maximize customer convenience. Other functional conflicts are evident in Figure 9-8. Without concerted effort toward the integration and coordination of functional strategies, these natural conflicts can contribute to the

figure 9-8
Logistic priorities in a manufacturing firm



Source: Adapted from John F. Stolle, "How to Manage Physical Distribution," *Harvard Business Review*, July–August 1967, p. 95.

failure of a business strategy, even if the separate functional strategies are independently well designed.

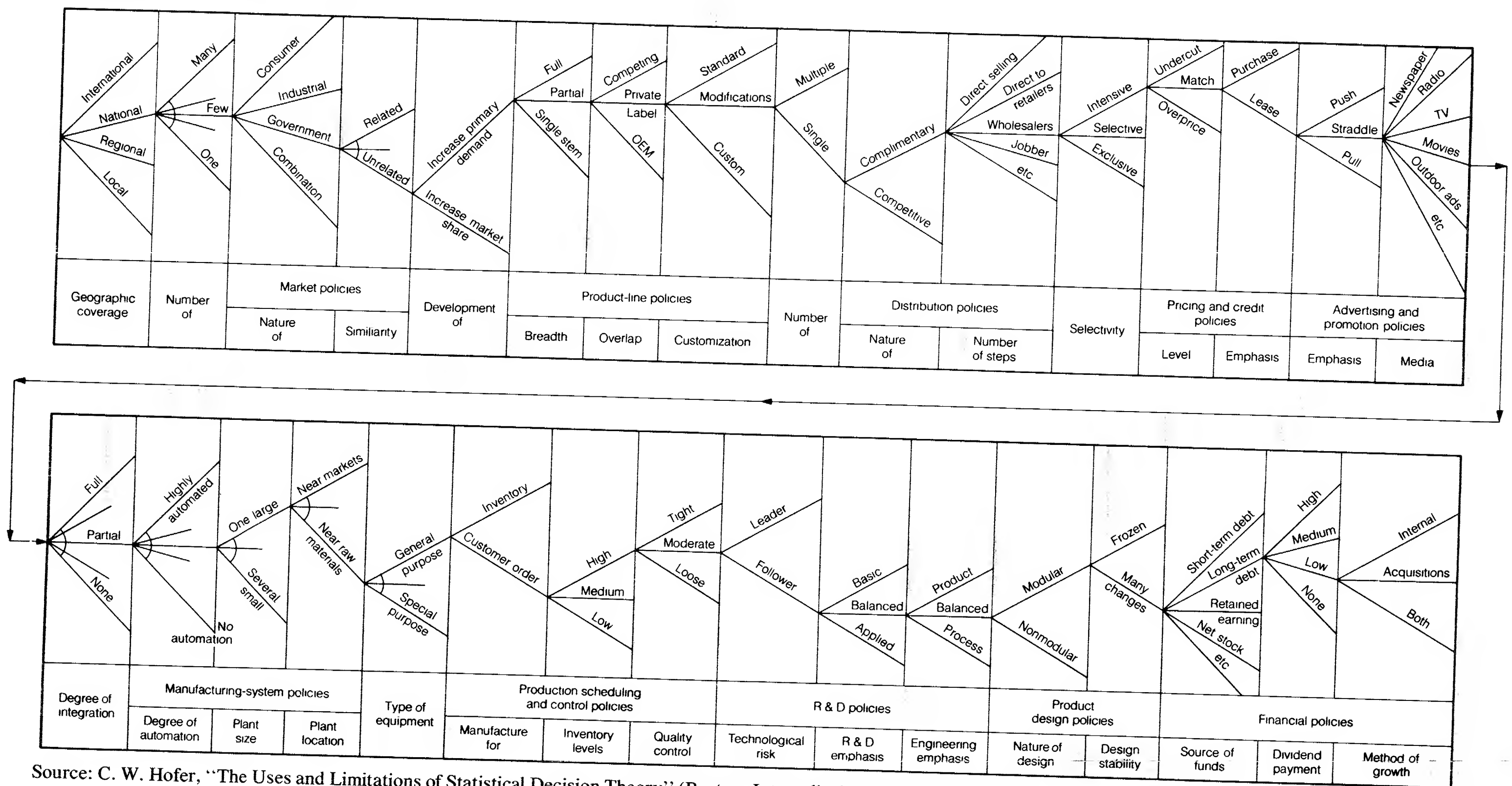
A second reason that comprehensive functional strategies, if developed separately, can contribute to the failure of a business strategy is the interdependence of functional actions. The success of functional strategy in one area is highly dependent upon the nature of functional strategies in other areas. Consider the case of Sears, the Chicago-based retailer. In support of a business-level growth strategy, Sears adopted a financial strategy of basing capital investment for new stores on past sales records. Its marketing/operations strategy, again in support of the business growth strategy, was seeking growth in the Sunbelt, consistent with population trends. These functional strategies are inconsistent. The financial strategy was allocating new store capital investment disproportionately to Sears' current strongholds and not to the Sunbelt. This inconsistency has been cited by some analysts as a major contributor to Sears' decline in recent years.

Now consider BIC, the manufacturer of ball-point pens, disposable lighters, and shavers. BIC has a production strategy of mass production incorporating state-of-the-art technology. Its marketing strategy has put increased emphasis on direct distribution to large retail outlets like K mart and Eckerds Drugs, while using national TV advertising to attract the ultimate consumer. BIC's financial strategy is to limit debt and credit to buyers and to streamline costs. All of these strategies are synergistic and reinforcing. They encourage high volume, rapid turnover, quick receipt of revenue, and internal generation of capital requirements.

The choices of functional strategy at Sears and BIC illustrate the interdependence of functional strategies. Figure 9-9 presents this functional interdependence in a more generalized, decision-tree format. It shows how the key decisions in functional areas, such as marketing, are interrelated with key decisions in other functional areas, such as finance. Implementation of a marketing strategy requires financial, operations, personnel, and logistics support. An effective financial strategy requires successful and consistent marketing and production/operations performance. Effectiveness of production/operations strategy requires coordinated financial decisions and marketing management. This is not to say that marketing success, for example, is solely dependent on financial and production strategies. However, the probability of meeting marketing objectives is very low if the marketing strategy is not integrated and coordinated with other functional strategies.

Strategically managed firms seek to achieve this integration and coordination by continually trying to reduce the uncertainty and inconsistency surrounding the interdependence of functional areas in the pursuit of organizational goals. Several mechanisms are part of this effort. A comprehensive business strategy is one important contributor to functional integration. Through the analysis leading to strategic choice and the communication of the chosen strategy, the business strategy should contribute to a narrowing of the uncertainty surrounding functional interdependence.

figure 9-9
A functional strategy decision tree



Source: C. W. Hofer, "The Uses and Limitations of Statistical Decision Theory" (Boston: Intercollegiate Case Clearing House, 9-171-653, 1971), p. 34.

Perhaps the most critical role in achieving integration of functional strategies is that of top management. It is their responsibility to ensure the success of the business strategy. Therefore, top managements' effectiveness is highly dependent upon identification and implementation of integrated functional strategies.

Past experience of the firm, particularly interrelationships of functional managers, should be a factor contributing to functional integration. Finally, the determination of annual objectives for the firm and its functional areas helps pinpoint inconsistencies and encourages coordination.

The role of annual objectives

Chapter 7 discussed the importance of long-term goals as benchmarks for corporate and business strategies. Measures like market share, ROI, return on equity (ROE), stock price, and new market penetration provide guidance and ability to assess the ultimate effectiveness of a chosen strategy. However, these broad measures cannot be directly linked to performance in functional areas.

In much the same way that functional strategies operationalize business strategy, annual objectives are necessary to operationalize the long-term objectives of the firm. Annual objectives differ from long-term objectives on four basic dimensions.

1. *Time frame.* Long-term objectives focus on the future, usually five years or more. Annual objectives focus on the immediate future, usually one year.
2. *Focus.* Long-term objectives focus on the future position of the firm in its competitive environment. Annual objectives identify specific accomplishments functional areas are responsible for.
3. *Specificity.* Long-term objectives are broadly stated. Annual objectives are very specific and directly linked to a functional area responsibility.
4. *Measurement.* While both long-term and annual objectives are quantifiable, long-term objectives are measurable in broad, relative terms, for example, 20 percent market share. Annual objectives are stated in absolute terms, directly traced to the performance of an organizational subunit.

Therefore, annual objectives provide specific, short-term benchmarks that can be used to monitor the effectiveness of a functional area strategy. Take the BIC example mentioned earlier. For 1982, BIC's functional area objectives might be:

Marketing: Increase the proportion of sales through direct distribution (to retails) to 90 percent of total sales.

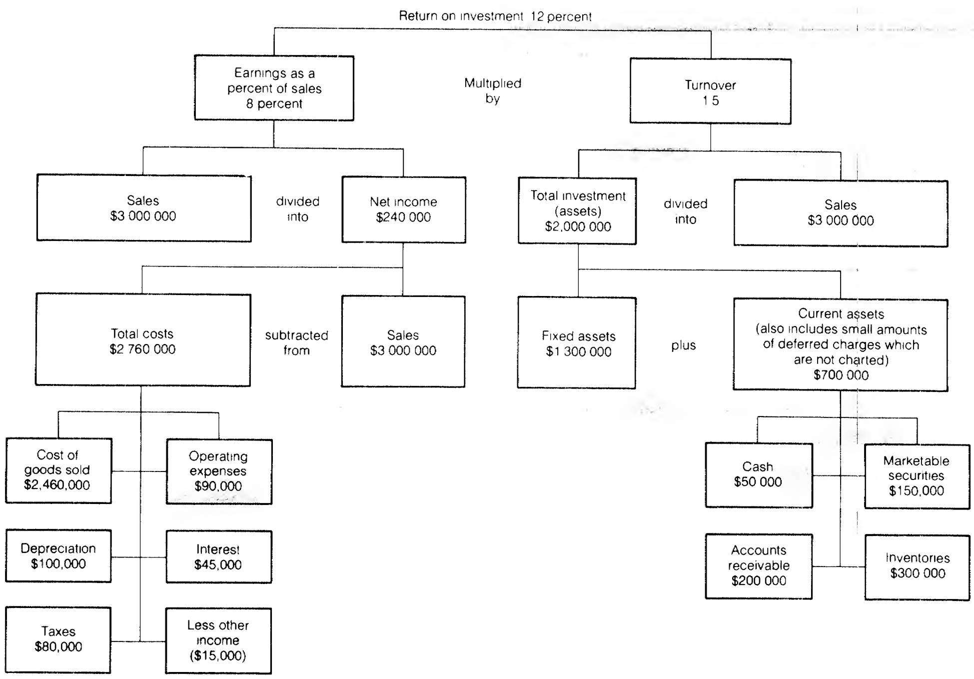
Finance: Maintain a debt-to-equity ratio of .15 and a quick ratio of 1.8 for 1982.

Production: Decrease labor costs to 10 percent of manufacturing cost by December 31, 1982.

These annual (functional) objectives provide specific direction to functional managers in the implementation of functional strategy. They provide a means to monitor the effectiveness of functional strategy and identify problem areas for adjustment—hopefully before the overall success of the long-range business strategy is seriously threatened.

Annual objectives are developed by functional managers in cooperation with each other and top management. These annual objectives should be developed as a logical extension of business strategy objectives. One tool used in the past by many companies in developing annual objectives is management by objectives (MBO). MBO can extend the objective-setting process from corporate objectives to individual managers if properly implemented. Figure 9–10 illustrates a similar procedure used in a division of the DuPont Chemical Company. Starting from a business-level objective (ROI of 12 percent), the diagram breaks down the implication of this goal in terms of the capital requirements, turnover, and cost structure of the firm. From this breakdown, functional managers could identify specific annual (functional) objectives associated with their functional area responsibilities.

figure 9–10
DuPont system of financial control



Source: Adapted from J. F. Weston and E. F. Brigham, *Essentials of Managerial Finance,* 3d ed. (Hinsdale, Ill.: Dryden Press, 1978), p. 47.

One last point. Specific objectives contribute to successful integration of functional strategies. The process of deriving the objectives as illustrated in the DuPont example can alert management to inconsistencies in functional strategies before it is too late. The communication of specific objectives across functional areas should enhance understanding and cooperation between functional area managers. Specific objectives channel individual efforts with greater likelihood of success.

Summary

This chapter has examined the role of functional strategies and annual objectives in the strategic management of a business firm. Both represent the beginning of implementation—operationalizing broad concepts at the business level into specific guidelines for functional action.

Functional strategies differ from corporate- and business-level strategies on three basic characteristics: time horizon, specificity, and participants. Functional strategies focus on the immediate future, provide specific guidelines for functional area actions and decisions, and incorporate multiple levels of management in their development.

Functional strategies must be formulated in key areas such as marketing, finance, R&D, POM, and personnel. The process of formulation across functional areas is quite similar. But the strategic issues addressed are very different. This chapter identified and discussed the key decision variables within each functional area.

While the decision variables and the content of strategy vary across functional areas, the interdependence of functional strategies is critical to success. As a result, major efforts must be taken to ensure the integration and coordination of functional area strategies. The responsibility for achieving integration and coordination of functional strategies lies particularly with top management and depends on the clarity and consistency of the business-level strategy.

Annual objectives are an important component of functional strategy implementation. They differ from long-term objectives in terms of specificity and time horizon. Annual objectives provide specific, short-term measures of the effectiveness of functional strategies. Deriving annual objectives can assist the integration and coordination of functional areas by enhancing the understanding of objectives across functional areas.

While functional strategies and annual objectives represent the start of implementation, much more remains. The next chapter looks at key factors in the total implementation and control of business strategy.

Questions for discussion

1. Explain the phrase "translate thought into action." How does this relate to the relationship between business strategy and functional strategy?

2. How do functional strategies differ from corporate and business strategies?
3. What are the key concerns that must be addressed in marketing strategy? Financial strategy? POM strategy?
4. How are these key concerns in conflict? Illustrate your answer.
5. How are these key concerns interrelated? Illustrate your answer.
6. What are the best mechanisms within a business firm for encouraging the integration and coordination of functional strategies? Explain how they would work.
7. Why are annual objectives needed when business goals are already available? What function do they serve?

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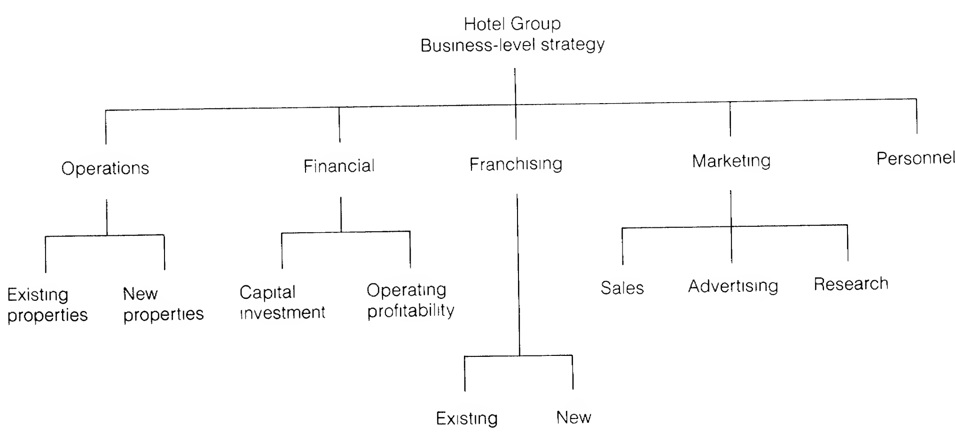
chapter 9 cohesion case
Functional strategies at Holiday Inns, Inc.

The Cohesion Case section in Chapter 8 discussed strategy evaluation and choice. It concluded with the identification of Holiday Inns' choice of corporate-level and business-level strategies. To implement these strategies, two basic things must be done. First, for each business group, functional strategies must be identified that operationalize the chosen grand strategy. Second, implementation tools like organizational structure, managerial assignments, reward systems, and control systems must be appropriately used to execute the strategy and monitor progress. In this Cohesion Case you will focus on identifying functional strategies to operationalize the business-level strategy. You will examine the use of implementation tools in Chapter 10.

Illustrating the choice of functional strategies for each business group at Holiday Inns, Inc. would require excessive text and time. Instead, we will isolate one business group—hotels—to illustrate the identification of functional strategies and annual objectives as discussed in Chapter 9. You should keep in mind, however, that a similar effort would be required for each business group at Holiday Inns to effectively begin the implementation of corporate-wide strategy.

Exhibit 1 diagrams the critical functional areas in which Holiday Inns seeks to clarify functional strategies that operationalize the business

exhibit 1
Functional strategy areas: Hotel group



strategy. We will briefly summarize the functional strategies and annual objectives that were chosen to operationalize the hotel business strategy for 1980. That summary is provided in Exhibit 2. This partially illustrates the nature of functional strategies at Holiday Inns, Inc. that are necessary to implement business strategy.

exhibit 2
Identification of functional strategies: Hotel group

Business-level strategy	*Long-term objectives*
Maintain and expand HI's leadership position in the lodging industry by providing the largest number of high-quality, moderately priced, full-service lodging facilities worldwide with emphasis on selective, company-owned expansion into multiuser-oriented properties and steady expansion through franchising with continuous updating or elimination of older properties.	Net addition of 70,000 new rooms by 1985 217,000 new and extensively renovated rooms in HI system by 1983 95 percent of all HI-owned properties in multiuser areas 50 new franchised properties per year 17 percent return on investment 40 percent debt-to-capitalization ratio Best price/value ratio in industry
Functional-area strategies	*Annual objectives*
Personnel. Ensure highly skilled, operating personnel for all hotel properties. To accomplish this, HI University offers one- to three-week courses for all new hotel managers, assistant managers, food and beverage managers, front office, sales, maintenance, and housekeeping supervisors with attendance mandatory.	Every new managerial or supervisory employee required to attend within one year Refresher courses mandatory every three years Average 2,500 people per year
Marketing. To clearly identify the typical HI guest, provide superior price/value lodging services desired, and ensure customer awareness that these services exist.	Above 74 percent system-wide occupancy rate
Marketing research. Make sure HI knows clearly who their customers are, what they want, and when and where to provide it via a continuous, $1.2 million annually budgeted consumer research program.	Clear identification of customer profile and changes in same
Advertising. Extensive magazine and TV advertising with largest industry budget and most recognized campaign—People Pleasing Places—in the industry.	Maintain 33 percent or greater customer preference for Holiday Inns
Sales. Offer the most advanced reservation system in the industry.	Lead industry in reservations Prebook over one third of system-wide room nights
Franchising. Maintain high level of franchise satisfaction and gradual expansion of franchise units system-wide	Average 50 new franchised properties 50 percent or higher of new units built by existing franchises

exhibit 2 ***(concluded)***

Functional-area strategies	*Annual objectives*
Financial. Maintain a financially sound capital structure relative to industry averages by using 50 percent internal and/or equity financing of company-owned expansion. Maintain sound profitability and stable growth by improving operating margins and a steady return on equity.	40 percent debt-to-capitalization ratio 17 percent operating margin (before taxes) 17 percent average return on equity
Operations. Ensure high-quality, standardized, superior service lodging facilities throughout the HI network. Emphasize quality control, particularly at existing facilities, and updating services offered system-wide to match changing customer profile and needs.	74 percent average occupancy rate system-wide
Quality control. At least one unannounced quality control inspection at every property twice annually. Also, achieve 50 percent of all system-wide rooms being either new or substantially renovated every five years.	Property failing two consecutive inspections is out of HI system.
Up-to-date services. Continuous improvement of services/facilities offered to match customer preferences. For example: "HI-NET" satellite communications network for multicity meetings and more king-size beds for increasing single and business guests.	74 percent average occupancy rate

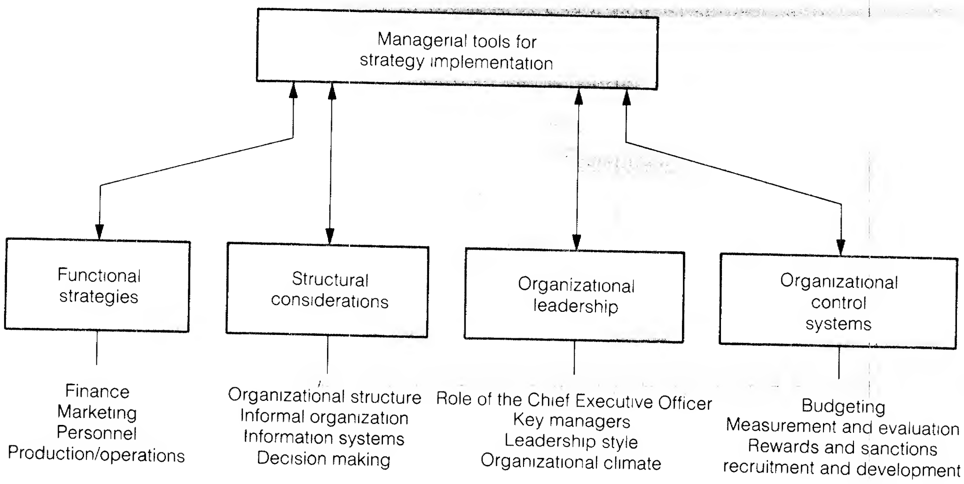
chapter 10

Strategy implementation and control

IN this chapter we turn our attention to what is often called the action phase of the strategic management process—the implementation and control of a firm's strategy. It is not enough that strategies have been formulated and evaluated. Organizational action requires more than intellectual analysis of the firm and its environment. If this analysis has been well done, then we have potentially sound strategy. But this strategy must be translated into concrete action and the action carefully controlled. Otherwise, accomplishment is left to chance. The systematic implementation of strategy is the initiation and management of organizational action. Without a doubt, it is a critical determinant of a firm's success.

What is involved in strategy implementation? Strategy implementation is the management of various managerial/organization tools that direct and control the use of the firm's resources (financial, people, equipment, and so on) in the pursuit of the chosen strategy. These tools can be divided into four broad categories: functional strategies, structural considerations, organizational leadership, and organizational control systems. Figure 10-1 identifies

figure 10-1
Managerial tools for strategy implementation



strategy in action, 10-1
Texaco Implements a New Strategy

From its position in the late 1960s as the largest U.S. petroleum marketer and producer, one of the largest holders of U.S. reserves, and the most profitable of the majors. Texaco dropped steadily to seventh place in profits by 1978. Remaining an oil company while the other majors shifted to new strategies as energy companies. Texaco is now scrambling to reposition itself with its own energy company strategy.

John McKinley, a chemical engineer who became Texaco's chairman on November 1, 1980, has already presented to the board his long-range plans. While the traditional oil business supplies the cash, the plan counts heavily on synthetic fuels and other high-technology alternative-energy products to provide the earnings base for the company in the 1990s. The strategy anticipates a gradual but steady shifting of capital investments away from conventional hydrocarbons and into coal gasification, shale oil, and tar sands projects. "People can still find oil and gas at lower cost than any of the alternate energy schemes," says McKinley, "but I see great movement toward alternate energy."

The direction of that total plan, however, is not remarkably different from that chosen by Texaco's peers 5 to 10 years ago. And many of the oil companies are well along in implementing their plans.

So perhaps even more important than the new plan's specifics, which will undoubtedly be revised from year to year, are the new management and planning systems Texaco is putting into place to streamline decision making, to open lines of communication among middle managers, and to decentralize power to make the company more responsive to changes in the economic and political climates. Such systems have been in place at most oil companies for most of the decade, but they represent a drastic change for Texaco. They include these arrangements:

A totally revised organizational structure, setting up geographic profit centers with responsibility for financial and operating decisions.

Basing bonuses mainly on performance instead of largely on seniority.

Recruiting at all levels rather than only at entry level.

Opening communications between line managers and between top managers and the public.

Encouraging and rewarding entrepreneurship at staff levels.

Texaco is matching the competition by restructuring the company into geographically defined operating units that amount to separate, integrated

strategy in action, 10-1 ***(concluded)***

oil companies. Each unit has profit and loss responsibility, and executive bonuses are tied to success in meeting divisional goals rather than to tenure.

An important goal of the restructuring is to push decision making down into the ranks—to make the people on the front lines more responsive and more responsible. Nevertheless, say Texaco observers, the success of that effort will depend more on the style of the people than on the structure of the company. McKinley realizes that their implementation will depend on an entirely new Texaco employee, one with an attitude vastly different from that of employees who have preceded him. When asked if his people can handle the new responsibilities they have been given, McKinley acknowledges that "the 'they' is a greatly changed thing." He points out that he is relying on a new and different team, backed by greatly increased flexibility, to accomplish his goals.

People who have followed Texaco or worked for it assign the blame for lack of flexibility to the corporate culture set by Augustus C. Long, the domineering Texas oilman who was Texaco's chairman for 10 years. Long, says a Wall Street analyst, "tended to surround himself with yes-men. What you've seen in the 1970s is a logical consequence of that."

"Gus" Long was also tightfisted. Decisions on even minor expenditures, such as remodeling service stations or replacing rusted storage tanks, required his approval. That penuriousness was reflected in Texaco salaries. A former staffer charges that "Texaco treated its middle managers like peons, and the managers came to believe they were."

McKinley has taken quite a different approach to implementing strategy. Commenting on his approach, McKinley concluded: "Nobody can assure you that any one organizational structure can do any specific thing. It's the people, the directions, the establishment of realistic strategic goals. But with all that," he adds. "You have to have an organization that is capable of reacting promptly, and you have to have aggressive leaders. We're moving in that direction."

Source: Based on the article "Texaco: Restoring Luster to the Star," from the December 22, 1980 issue of *Business Week*.

the managerial tools that are the mechanisms for implementing strategy. To effectively direct and control the use of the firm's resources, mechanisms such as organizational structure, information systems, leadership styles, assignment of key managers, budgeting, rewards, and control systems are essential strategy implementation ingredients.

Management must formulate and communicate detailed functional strategies, consistent with the chosen strategy, that guide operational actions within each business unit. They provide a major link between strategy formulation and organizational action as well as a test of the grand strategy's soundness. Still more is needed. Strategic managers must examine the exist-

ing organizational structure, adjusting and redesigning it to accommodate the unique needs of the chosen strategy. Their focus should be on both the formal structure and the informal organization, seeking to design the flow of information and responsibility to accommodate effective action. Organizational leadership should be a part of strategic managers' implementation decisions. They must examine organizational climate, leadership, and management personnel with the purpose of ensuring a climate and leadership consistent with the needs of the strategic choice. Finally, various organizational systems—like budgeting and control, compensation and rewards, and recruitment—must be reviewed, developed, and adjusted to foster control and purposeful action in concert with the grand strategy.

Each of the implementation tools constitutes a major topic unto itself and is the focus of extensive writing, research, and commentary. Full coverage of each topic is beyond the scope of this book. Therefore, we seek to introduce you to the strategic concerns associated with each of these tools in making a decision regarding their use for implementing strategy. These tools are conceptually divided and presented to facilitate orderly discussion. In actuality, the use of these tools is always intertwined. For example, the choice of organizational structure should be interrelated with the assignment of key managers, functional strategies, and resource allocation within the firm.

Functional strategies

Functional strategies were examined in detail in Chapter 9. However, one important point—functional strategies as the beginning of strategy implementation—deserves further elaboration.

Functional strategies are a critical link between strategy formulation and strategy implementation. First, deriving functional strategies requires both the conceptual/analytical thought process underlying strategy formulation and the action orientation of strategy implementation. Second, developing action-oriented functional strategies provides a kind of ***last chance test of consistency*** for the formulated business strategy before organizational action is initiated. In other words, functional strategies force business strategists to *directly* consider the various operational requirements for the strategy in light of the actual operating capabilities of the firm. In the mechanical writing instrument industry, for example, Scripto sought industry dominance through a strategy of being the only full-line producer in the industry. Its functional marketing strategy was to rely on customer awareness of the Scripto name, serve all market distribution channels, and spread a limited advertising budget across virtually all products and markets. This marketing strategy was given little in-depth consideration, but rather was adopted as a logical necessity for Scripto's full-line strategy. Had this marketing strategy been thoroughly considered, forcing a true evaluation of marketing requirements relative to Scripto's capabilities, management might

have realized that Scripto did not possess the marketing resources and capabilities to support such an endeavor, nor were marketing trends (market segmentation by price, channel, and product and heavy advertising expenditures in selected segments) in the industry consistent with such a strategy. While Scripto declined, BIC, with thoroughly considered functional strategies, rose to dominance in selected key segments of the mechanical writing industry. Thus, carefully considered functional strategies offer a final, pre-action evaluation of a business strategy and a reality-based guide to organizational action.

As detailed guides to action, functional strategies provide a key tool in strategy implementation. The bottom line of strategy implementation is coordinated day-to-day actions of organizational members culminating in effective strategy execution. Paradoxically, most of these members have not participated in business strategy formulation. Therefore, functional strategies (along with other implementation tools) offer the first explanation of a business's strategy to most organizational members. Clearly, detailed functional strategies can serve a major role in guiding the desired execution of an otherwise unfamiliar business strategy. As a concrete link to past ways of doing things, functional strategies can alert operational managers to specific activities they must change or retain to support the new strategy.

Functional strategies address two additional issues that have an important impact on strategy implementation: (1) the integration of various subfunctional activities and (2) relating functional area policies to changes in functional area environments.[1] For example, a firm's marketing strategy should try not only to effectively integrate decisions with respect to product pricing, promotion, market channels, and sales staff. It should also seek to ensure that these decisions are consistent with changing practices in each of these areas.[2] In the mechanical writing industry, for example, the emergence of large retail chains (such as K mart and Eckerd drugstores) has brought about a change in market channels. In the past, producers used distributors who sold to numerous retail outlets like office supply stores and independent druggists. Today this practice is changing, and a product is sold directly to large retailer market channels by the manufacturer.

Finally, detailed functional strategies enhance strategy implementation by alerting management to critical interdependencies between certain functional areas. For example, success of a marketing strategy may depend heavily on certain inventory levels and warehousing logistics which in turn are predicated on certain financing arrangements. The successful coordination of these functional interdependecies is the role of business-level strategy and management. But thorough development of functional strategies can

[1] Charles W. Hofer, E. A. Murray, Ram Charan, and Robert A. Pitts, *Strategic Management: A Casebook in Business Policy and Planning* (St. Paul, Minn.: West Publishing, 1980), p. 14.

[2] Ibid., p. 14.

suggest the need for other strategy implementation tools in coordinating these interdependencies. One such tool that might be called for is organizational structure.

Structural considerations

Accomplishment of strategic purpose logically requires organization. A major priority in the implementation of a carefully formulated strategy should be a planned organizational structure. Without deliberately organizing the activities, responsibilities, and interrelationships consistent with the needs of the chosen strategy, the structure is left to evolve. Uncontrolled evolution of organizational structure denies the opportunity of unique coordinates between structure and strategy, likely leading to inefficiencies, misdirection, and fragmented efforts. In a small firm where one person can manage current operations and plan for the future, the question of organizational structure is relatively unimportant. The owner-manager has no organizational problem until his hurried trips to the plant, late-night sessions assimulating financial information for his CPA, and pressed calls on potential customers are inadequate to meet the demands of the business's increasing volume. With the magnitude of business activity increasing, the need to subdivide activities, assign responsibilities and provide for the integration and coordination of the newly created parts becomes imperative. The question of how to structure the organization to effectively execute its strategy has become a strategic concern.

Structure is not an end in itself. It is a means to an end. Structure is a tool for managing the size and diversity of a business to enhance the success of its strategy. This section will help you understand organizational structure as an implementation tool by identifying structural options, the role of structure in implementation, and how structure is chosen.

What are the choices? There are five basic structures currently in use by most business firms.

1. Primitive.
2. Functional.
3. Divisional.
4. Strategic business units.
5. Matrix organization.

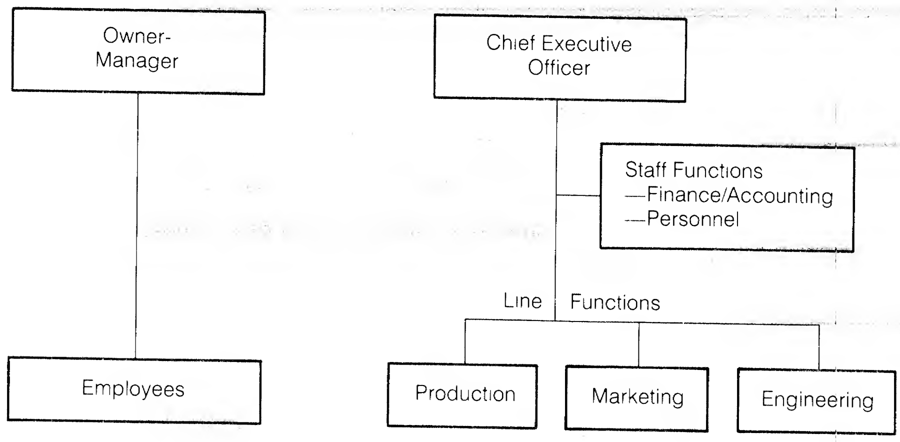
While the diversity and size of business organizations necessitate unique structural needs for each firm, these five structural choices represent basic underlying features similar to most business organizations.

Primitive and functional organizational structures

Figure 10–2 illustrates the primitive and functional organizational structures. In the smallest business enterprise the primitive structure prevails. All

figure 10-2
Primitive and functional organizational structures

A. Primitive Structure B Functional Structure



A. Advantages

1. Facilitates control of all the business's activities.
2. Rapid decision making and ability to change with market signals.
3. Simple and informal motivation/reward/control systems.

A. Disadvantages

1. Very demanding on the owner-manager.
2. Increasingly inadequate as volume expands.
3. Does not facilitate the development of future managers.
4. Tends to focus chief executive officer on day-to-day matters and not future strategy.

B. Advantages

1. Efficiency through specialization.
2. Enhanced development of functional expertise.
3. Differentiates and delegates day-to-day operating decisions.
4. Retains centralized control of strategic decisions.

B. Disadvantages

1. Promotes narrow specialization and potential functional rivalry or conflict.
2. Difficulty in functional coordination and interfunctional decision making.
3. Staff-line conflict.
4. Limits internal development of general managers.

strategic and operating decisions are centralized within the owner-manager's domain. With the strategic concern primarily survival, and the likelihood that one bad decision could seriously threaten continued existence, this structure maximizes the owner's control. This structure facilitates rapid reponse to product/market shifts and the ability to accommodate unique customer demands without coordination difficulties. Primitive structures encourage employee involvement in more than one activity of the business and thrive in businesses that serve a localized, simple product/market. This structure can be very demanding on the owner-manager, often demanding increased attention for day-to-day concerns as volume increases at the expense of time for strategic planning.

The functional organization is the predominant structural choice in numerous business firms. This is particularly true among medium-sized firms in single product/markets. Functional structures group similar tasks and activities together (usually production/operations, marketing, finance/accounting, research and development, personnel) as separate organizational units. This specialization encourages greater efficiency and refinement of specialized expertise. This allows the firm to seek and foster distinct competencies in one or more functional areas. This expertise is critical to single product/market companies and firms that are vertically integrated. Indeed these are often the medium-sized firms we mentioned above that show a strong preference for functional structures.

As one might expect, the strategic challenge in the functional structure is effective coordination of these separate functional units. The underlying paradox of this structure is that the narrow technical expertise sought through specialization can lead to limited perspectives and different ways of doing things across functional units. Functional specialists may not have an understanding of other functional problems and begin to see the firm's strategy primarily as a marketing problem or a production problem. This potential paradox makes the coordinating role of the chief executive a critical one in a functional structure.

Divisional organizational structure

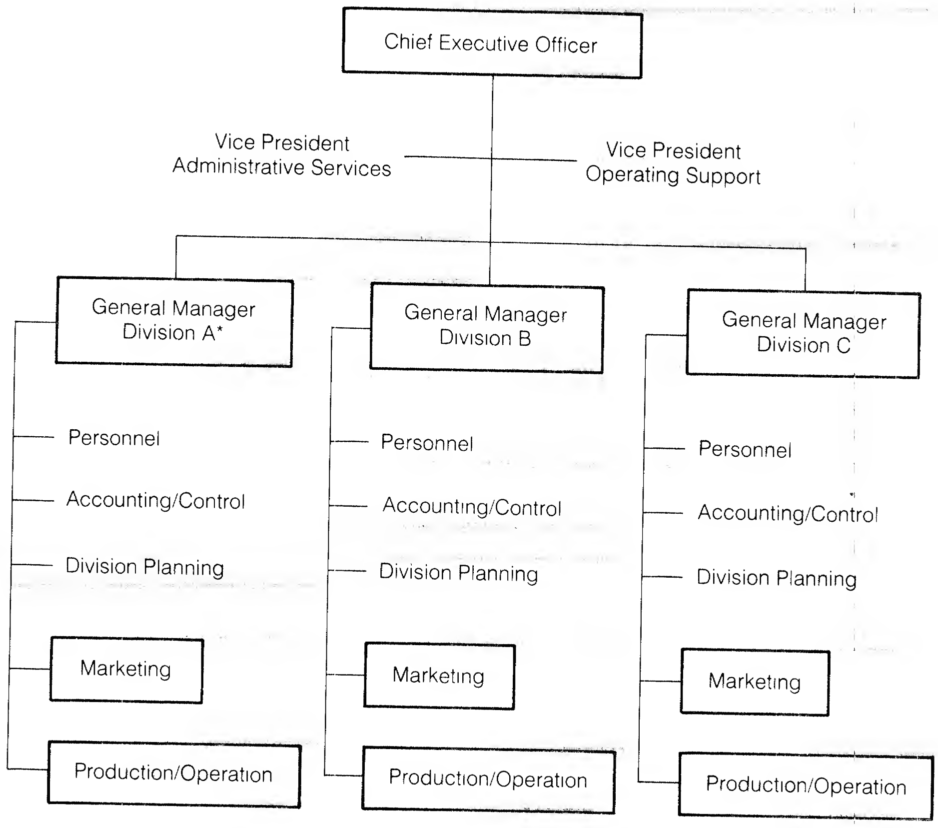
When a firm diversifies its product/service lines, covers broad geographic areas, utilizes unrelated market channels, or begins to serve distinctly different customer groups, a functional structure rapidly becomes inadequate. Functional managers may be overseeing the production or marketing of numerous and different products or services. Operational coordination demands on top management are beyond the capacity of the centralized functional structure. Some form of divisional structure is necesary to facilitate the coordination and decision-making requirements brought on by increased diversity and size. Figure 10–3 illustrates a divisional structure.

A divisional organization permits corporate management to delegate major authority to division managers for the strategic management of a distinct business entity. This can expedite critical decision making within each division in response to varied competitive environments. It forces corporate management to concentrate on corporate-level strategic decisions. These semiautonomous divisions are given profit responsibility and the divisional structure facilitates more accurate assessment of profit and loss. Classic examples of divisional structures include Ford and General Motors.

Strategic business units

Some divisionally structured firms begin to encounter difficulty in controlling their divisional operations as the diversity, size, and number of these units increase. Corporate management encounters difficulty in knowl-

figure 10-3
Divisional organization structure



Advantages

1. Forces coordination and necessary authority down to the appropriate level for rapid response.
2. Places strategy development and implementation in closer proximity to the divisions unique environment.
3. Frees chief executive officer for broader strategic decision making.
4. Sharply focuses accountability for performance.
5. Retains functional specialization within each division.
6. Good training ground for strategic managers.

Disadvantages

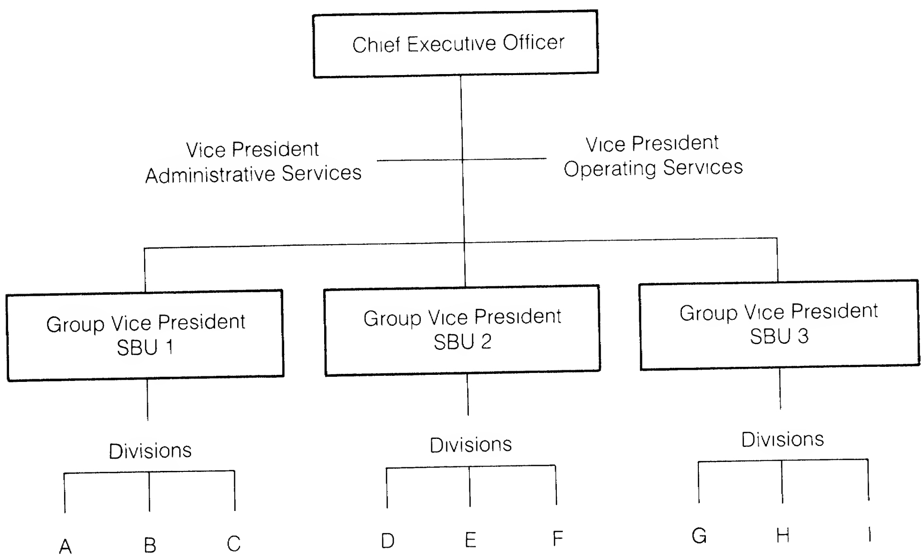
1. Fosters potentially dysfunctional competition for corporate-level resources.
2. Problem of the extent of authority given to division managers.
3. Distribution of corporate overhead costs.
4. Potential for policy inconsistencies between divisions.

* The divisions might be for different product lines, geographic segments, distinctly different market channels or customer groups. The functions included under the division manager's domain would vary with each of these bases for divisionalization. For example, divisions based on market channels might not include the manufacturing function. This might still be centralized. The same could hold for customer-based divisionalization. The above figure is typical for a manufacturing firm with diverse product line and/or geographic location.

edgeably evaluating and controlling its numerous, often multi-industry divisions. Often, significant increases in sales are not accompanied by similar improvement in profitability. In this case, it may be necessary to add another layer of management to improve the strategic management and gain greater control of such diverse business interests. This can be accomplished by grouping various divisions (or parts of some divisions) based on common strategic elements. These groups, commonly called strategic business units (SBUs), are usually partitioned according to independent product/market segments served by the firm.

Figure 10-4 illustrates an SBU organizational structure. General Electric, faced with massive sales growth but little profit growth throughout the 1960s, was an early pioneer in the SBU-type organization. GE restructured over 48 divisions into 43 SBUs where, for example, three separate divisions making food preparation appliances were merged into a single SBU serving

figure 10-4
Strategic business unit organizational structure



Advantages

1. Improves coordination between divisions with similar strategic concerns and product/market environments.
2. Tightens the strategic management and control of large, diverse business enterprises.
3. Facilitates distinct and in-depth business planning at the corporate and business levels.
4. Channels accountability to distinct business units.

Disadvantages

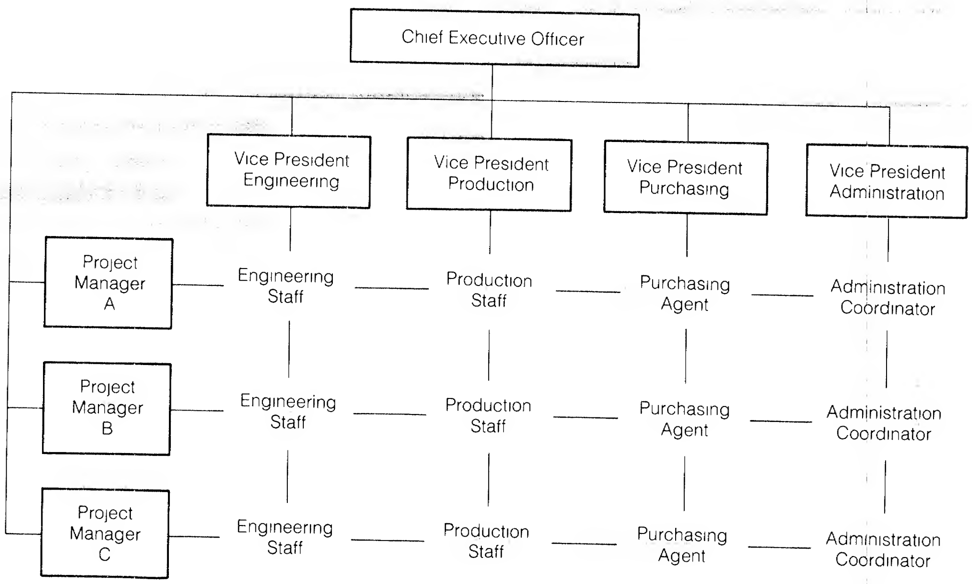
1. Places another layer of management between the divisions and the corporate management.
2. Dysfunctional competition for corporate resources.
3. The role of the group vice president can be difficult to define.
4. Defining the degree of autonomy for the group vice presidents and division managers.

the housewares market.[3] General Foods, after originally defining SBU's along product lines (which served overlapping markets), restructured their SBU's along menu lines. SBU's for breakfast foods, beverages, main meal, dessert, and pet foods allowed General Foods to target specific markets.[4]

Matrix organization

Another organizational structure encountering increased use particularly with firms like defense contractors, construction companies, and large CPA firms is the matrix organization structure. These firms typically work on numerous projects, of limited and varied duration, simultaneously. The matrix organization provides for dual channels of authority, performance responsibility, evaluation, and control as shown in Figure 10–5. Essentially,

figure 10–5
Matrix organizational structure



Advantages

1. Accommodates project-oriented business activity of wide variety.
2. Good training ground for strategic managers.
3. Maximizes efficient use of functional managers.
4. Fosters creativity and multiple sources of diversity.
5. Broader middle management exposure to strategic issues for the business.

Disadvantages

1. Dual accountability can create confusion and contradictory policies.
2. Necessitates tremendous horizontal and vertical coordination.

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[3] William K. Hall, "SBUs: Hot, New Topic in the Management of Diversification," *Business Horizons*, February 1978, p. 19.

[4] Ibid., p. 19.

subordinates have a dual assignment—to their basic functional area and to the project or product.

The matrix organization can accommodate a varied and changing project or product/market/technology focus. It can increase the efficient use of functional specialists who otherwise might encounter downtime. This structure increases the number of middle managers exercising general management responsibilities. It also broadens their exposure to organization-wide strategic concerns.

strategy in action, 10–2

Shell Oil: Matrix Structure to Implement Corporate Strategy

Fifteen miles off the coast of Louisiana, a giant platform called Cognac rattles and shakes under the ceaseless activity. Hard-hatted roughnecks are spudding a new well, sending drilling bits twisting 1,200 feet through the choppy waters to reach rich reservoirs of crude oil beneath the Gulf of Mexico's floor. Meanwhile, 60 other wells drilled from the massive midsea factory shoot crude through a ganglion of pipe to onshore refineries and chemical plants, where it will be transformed into everything from gasoline to contact lenses. Everthing about the Cognac field is imposing. It represents a capital investment of about $800 million by a consortium headed by giant Shell Oil Company. And every 24 hours it gushes out an awesome return: 16,000 barrels of oil worth $576,000 at current prices.

Cognac, a mere blip on the Shell balance sheets, is a microcosmic example of the stupefying risks and rewards of the modern oil business for Shell.

Shell, which analysts consider one of the best-run companies in the industry, employs a strategy different from that of competitors. Shell's corporate strategy focuses almost exclusively on the development of energy resources and petrochemicals.

Managing by matrix. To make and implement the far-reaching decisions this strategy requires, Shell management relies on what is known in business school jargon as a *matrix system*. Like most large corporations, Shell has managers who report to general managers who report to vice presidents. But it also has a network of interlevel, interdivisional teams that try to coordinate the activities of everyone from petroleum engineers to public relations specialists. As a result, more employees participate in decision making and understand the reasons for policies before they are dictated. And in theory, at least, the system helps guard against redundant

strategy in action, 10–2 ***(concluded)***

activities. Instead of maintaining separate research projects for exploration and production, oil products, and chemicals, Shell has a single research division that serves the entire company.

The matrix can be exasperating at times. "We meet ourselves to death," complains Ken Spaulding, manager of chemical-products plans. But it reinforces Shell's policy of delegating responsibility to "the level of maximum knowledge." J. B. Henderson, the president of Shell Chemical Co., for instance, doesn't decide whether or not to buy a certain cargo of crude oil for his facilities. "I can't make the decision intelligently," he says. "Someone in the buying depa·tment can."

Source: "Inside the Shell Oil Company," *Newsweek*, June 15, 1981, pp. 72–77. Condensed from *Newsweek*. Copyright 1981, by Newsweek, Inc. All rights reserved. Reprinted by permission.

From the primitive structure to the matrix organization, you have been introduced to five general organizational structures. Other structures, primarily adaptions of these five, surely exist, but additional coverage is not warranted. Rather, with this basic exposure to the choices available, the important issue for you to consider is the role of structure in strategy implementation and on what basis to choose one structure over the others.

The role of structure: Linking structure to strategy

Which structure is best? Considerable research has been done on this question and the collective answer is that it depends on the strategy of the firm. The structural design, tying together key activities and resources of the firm, must be closely aligned with the needs/demands of the firm's strategy.

Alfred Chandler provides the landmark study that helps understand the choice of structure as a function of strategy.[5] Studying 70 large corporations over an extended time period, Chandler found a common strategy-structure sequence consisting of (1) the choice of a new strategy, (2) emergence of administrative problems, a decline in performance, (3) a shift to an organizational structure more in line with the strategy's needs, and then (4) improved profitability and strategy execution. General Electric's recent history supports Chandler's sequential thesis. Operating with a simple divisional structure in the late 1950s, GE embarked on a broad diversification strategy. In the 1960s, GE experienced impressive sales growth. However, GE also experienced administrative difficulties in trying to control and improve the lack of a corresponding increase in profitability. In the early 1970s, GE executives redesigned the organizational structure to accommodate the administrative needs of the strategy (ultimately choosing the strategic business unit type structure), subsequently experiencing improved profitability and better control over the execution of the diversification strategy.

[5] Alfred D. Chandler, *Strategy and Structure* (Cambridge, Mass.: MIT Press, 1962).

Chandler's research and the GE example provide us with two important observations. First, all forms of organizational structure are not equally effective in implementing a strategy. Second, structures seem to have a life of their own, particularly in larger organizations. As a result, the need for immediate and radical changes in structure are not immediately perceived. Once perceived, politically sensitive structural changes or redistributions of organizational power often need the impetus of lagging performance to hasten their adoption.

Further understanding of the structure-strategy relationship comes from several stage of development researchers.[6] Studying numerous business firms, these researchers have concluded that business firms move through several stages as the size and diversity of the firm increases. Figure 10-6 synthesizes their stage of development theories. As the firm moves through each stage, the firm's size, diversity, and competitive environment change.

figure 10-6
Corporate stages of development

Stage	*Characteristics of the firm*	*Typical structure*
I	Simple, small business. Offering one product/service or one line of products, services to a small, distinct local or regionalized market.	Primitive to functional
II	Singular or closely related line of products/services but to a larger and sometimes more diverse (geography, channels, or customers) market.	Functional to simple divisional
III	Expanded but related lines of products/services to diverse, large markets.	Divisional to matrix
IV	Diverse, unrelated lines of products/services to large, diverse markets.	Divisional to SBUs

To compete effectively at different stages requires, among other things, a different structure. Again, we see the choice of structure contingent upon the strategy of the firm in terms of its size and the diversity of the products/services offered and the markets served. Two firms in the metal container industry help illustrate this point. Continental Can, the industry leader, employs a divisional structure to implement a diversification strategy that seeks to serve virtually every user of metal containers, as well as compete in unrelated markets like forest products. Crown, Cork and Seal, the industry's fourth largest company, employs a modified functional structure as it serves a limited domestic and international market of metal can users

[6] Several authors have addressed the stage of development area. Some of the more frequently cited include J. T. Cannon, *Business Strategy and Policy* (New York: Harcourt Brace Jovanovich, 1968), pp. 525-28; Malcomb Salter, "Stages of Corporate Development," *Journal of Business Policy* 1, no. 1 (1970): 23-37; Bruce Scott, "Stages of Corporate Development—Part I and II," mimeographed (Boston: Harvard Business School, 1970); and Donald H. Thain, "Stages of Corporate Development," *Business Quarterly*, Winter 1969, pp. 33-45.

with specialized container needs. Both firms are successful. Both derive their greatest revenues from the same industry. But each employs a different organizational structure because their strategies (and stages of development) are different.

The choice of structure must be determined by the firm's strategy. The chosen structure must segment key activities and/or strategic operating units to enhance their efficiency through specialization, response to a competitive environment, and freedom to act. At the same time, the structure must effectively integrate and coordinate these activities and units to accommodate interdependence among activities and overall control. The choice of structure reflects the needs of strategy in terms of the firm's (1) size, (2) product/service diversity, (3) competitive environment and volatility, (4) internal political considerations, and (5) the information/coordination needs of each component of the firm. Strategy in Action 10–3 illustrates how structure was tied to strategy at Crown, Cork and Seal.

strategy in action, 10–3
Linking Structure to Strategy at Crown, Cork and Seal

At the end of the 1950s, John Connelly became chief executive officer at Crown, Cork and Seal Company (CCS). A major company in the metal container industry, CCS had fallen on hard times. Trying to compete on all fronts with much larger competitors like American Can Company and Continental Can Company, CCS had become overextended and was on the verge of bankruptcy. It had a product-oriented, divisional organization structure, similar to its larger competitors, which had been adopted to facilitate decentralized competition.

Connelly formulated an urgent retrenchment strategy to turn CCS around. The strategy focused CCS in the production of cans for hard-to-hold products, aerosol cans, and evolving international markets. The emphasis of this strategy was to sell to large can purchasers and to provide them with extensive service in their canning operations. Thus Connelly's strategy was to narrow CCS's scope to the most profitable product/market segments, build a service-related competitive advantage, and maintain tight fiscal control to overcome the imminent threat of bankruptcy.

To implement this strategy, Connelly quickly realized the existing divisional structure was not consistent with the needs of the new strategy. The extra corporate-level overhead was both costly and unnecessary given the narrowed scope of CCS operations under the new strategy. To accommodate its narrow product/market scope, and the need for tight

strategy in action, 10-3 ***(concluded)***

fiscal control, Connelly reorganized CCS along functional lines with three vice presidents—manufacturing, sales, and finance—reporting directly to him. This provided the centralized control the retrenchment strategy needed. It cut the managerial labor force by 24 percent. And by making plant managers responsible for the profitability of their operations, he accommodated the strategy's need for tight control of geographically dispersed units within an efficient, streamlined, functional structure.

CCS's strategy has been quite effective with CCS consistently leading the industry in return on equity, profitability, and return on investment. And the success of this strategy was clearly linked to an appropriate organizational structure and the strong, forceful leadership of John Connelly.

Even a change in strategy, with its accompanying alteration of administrative needs, does not lead to an immediate change in a firm's structure. In reality, the research of Chandler and others suggests that commitment to a structure lingers even after its appropriateness for a current strategy has diminished.[7] Whether it is due to inertia, organizational politics, or a realistic assessment of the relative costs of immediate structural change, historical evidence suggests that the existing structure will be maintained and not radically redesigned until a strategy's profitability is increasingly disproportionate with increasing sales.[8]

Organizational leadership

While organizational structure provides the overall framework for strategy implementation, it is not in itself sufficient to ensure successful execution. Within the organizational framework, individuals, groups, and units are the mechanisms for organizational action. It is the effectiveness of their actions that is a major determinant of successful strategy implementation. Two sets of managerial tools are available to encourage effective action—leadership and controls. This section examines the dimensions of leadership as a managerial tool in strategy implementation. Following this section, the use of controls to effectively execute strategy will be discussed.

Leadership, while seemingly vague and esoteric, is an essential tool for effective strategy implementation. There are three dimensions of leadership that are important to strategy implementation: (1) role of the chief executive officer (CEO), (2) assignment of key managers, and (3) managerial leadership styles.

[7] Chandler, *Strategy and Structure*; and J. R. Galbraith, and D. A. Nathanson, *Strategy Implementation: The Role of Structure and Process* (St. Paul, Minn.: West Publishing, 1978).

[8] Hofer, et al., *Strategic Management*, p. 19.

Role of the CEO

The chief executive officer is the central catalyst throughout the strategic management process. This individual is the one who is most closely identified with and ultimately accountable for a strategy's success. In most firms, particularly larger ones, CEOs spend up to 80 percent of their time developing and guiding strategy.

Thus, the CEO is a major leadership tool in strategy implementation. First, the CEO is a symbol of a new strategy. The CEO's actions and the perceived seriousness of commitment to a chosen strategy, particularly when the strategy is a major shift from the past, exert a major influence on the intensity of subordinate managers in strategy implementation. The CEO's behavior greatly influences the organizational climate for strategy execution. Second, the firm's mission, strategy, and key long-term objectives are strongly influenced by the personal goals and values of its CEO. With the extent of the CEO's investment of time and personal values in the chosen strategy, the CEO represents an important source for clarification, guidance, and adjustment during strategy implementation.

Major changes in the strategy of most firms are often preceded or quickly followed by a change in CEOs. The timing of this occurrence suggests that different strategies require different CEOs if the strategy is to succeed. The resignation of L. M. Clymer as CEO at Holiday Inns, Inc. clearly illustrates this point. With Holiday Inns' executive group convinced that casinos provide a key growth area for the company, Clymer choose to resign because his personal values and perception of what Holiday Inns should be were not consistent with this change. Research examining turnabouts, for example, has concluded that a successful turnaround strategy "will require almost without exception either a change in top management or a substantial change in the behavior of the existing management team."[9] Clearly, successful strategy implementation is directly linked to the unique characteristics, orientation, and actions of the individual CEO.

Assignments of key managers

A major concern of top managers as they seek to implement a strategy, and particularly a major change in strategy, is to make sure that they have the right managers in the right positions for the new strategy. Of all the tools for ensuring successful strategy implementation, this is the one which CEOs mention first. Confidence in the individuals that occupy pivotal managerial positions is directly and positively correlated with top-management expectations that a strategy can be successfully executed.

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[9] Charles W. Hofer, "Turnaround Strategies," *Journal of Business Strategy* 1, no. 1 (1980): 25.

How is this confidence achieved? Once a strategy is chosen, top management must ask at least two basic questions:

1. Who holds the current leadership positions that are especially critical to strategy execution?
2. Do they have the right characteristics to assure that the strategy will be effectively implemented?[10]

What characteristics are the most important ones to consider? It would be impossible to specify precisely which characteristics all top managers look for. Typical characteristics that are likely to be considered include (1) ability and education, (2) previous track record and experience, and (3) personality and temperament.[11] These, combined with gut feeling and top managers' confidence in the individual, provide the basis for this key decision.

The important issue seems to be matching the manager's characteristics with the needs of the aspect of the strategy the manager will be asked to implement. For example, Figure 10–7 broadly illustrates the different types of managers that would be desirable to implement different strategies. This figure illustrates how different managers might be assigned to match the strategy for a particular business unit.

Exxon, for example, has numerous business units operating under Exxon's corporate umbrella. Two such units are International Marine Transportation (a tanker leasing operation) and Exxon Enterprises (the new-business development arm of Exxon). While the tanker leasing operation has followed a strategy of retrenchment in the face of a worldwide oil surplus, Exxon Enterprises has been strongly pushing its office equipment venture as the market is rapidly growing. To successfully implement the strategy in each of these units, it is no surprise that Exxon's corporate management has sought very different managers in terms of training, experience, and temperament to implement the respective strategies. The assignment of key managers, attempting to match individuals' characteristics with the critical needs of the strategy, is a difficult task. The types of managers and types of strategies shown in Figure 10–7 are just that—ideal types. It is a challenge, to say the least, to transpose Figure 10–7's matching notion to unique, individual managers. But the difficulty of the challenge does not diminish the importance of this tool in strategy implementation.

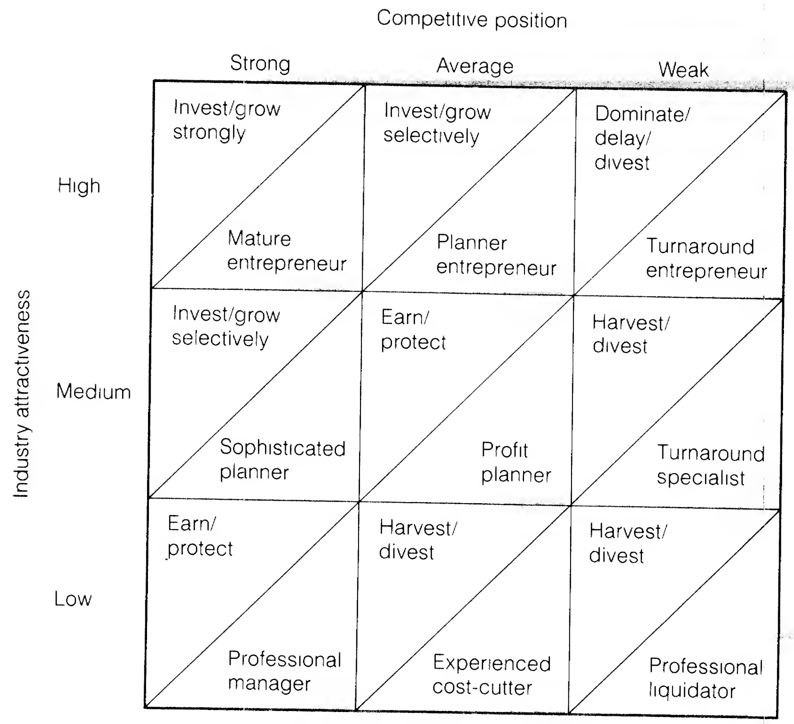
Managerial leadership styles

In addition to the importance of matching individual characteristics with the needs of strategy, the style that a manager uses in working through others can be an important factor in strategy implementation. There have been

[10] William F. Glueck, *Strategic Management and Business Policy* (New York: McGraw-Hill, 1980), pp. 306–7.

[11] Ibid., p. 307.

figure 10-7
The types of managers needed to manage different types of business-level strategies



Source: Adapted from C. W. Hofer and M. J. Davoust, *Successful Strategic Management* (Chicago: A. T. Kearney, 1977), pp. 45, 82.

volumes of research examining leadership styles. One result has been a potpourri of terms with which to classify managerial leadership styles. Autocratic, democratic, participative, conservative, entrepreneurial, instrumental, laissez-faire, negotiator, great person, muddling-through, and Theory X, Y, and Z are but a few of the terms that have been coined to describe leadership styles.

You have no doubt studied some of these leadership styles in earlier courses. For example, an autocratic manager, in leading an organizational unit, tends to command, make most decisions, be assertive, dogmatic, extremely self-confident, and rely primarily on authority, discipline, and tight control. The participative manager, in leading an organizational unit, tends to delegate, encourage subordinate initiative and participation in decisions, and generally act as a coordinator of and resource for subordinate performance.

Rather than offering additional definitions, the important concern is really which leadership style is the most effective for managing an organizational

unit in the execution of a strategy. Increasing evidence suggests that no leadership style is universally the best. Rather, for managers to effectively lead an organizational unit toward effective strategy execution, they will tend to vary their leadership style as people, tasks, organizational environment, and the needs of strategy vary.[12] Returning to Exxon's Office Equipment division, for example, the factors (people, task, environment, and functional strategy) that the marketing manager confronts may be quite different than those confronting the manufacturing manager. And at a higher level at Exxon, the factors confronting the general manager of the fast-growing office equipment division and the general manager of the declining marine transport division may be quite different. Consequently, it would not be surprising if each of these managers adopted a different style in leading their respective organizational units.

Thus, leadership style can have an important impact on how effectively a strategy is implemented. Whether or not the manager makes a conscious decision to lead via a certain style, the leadership style that results will have a major influence on the organizational climate. The leadership style that is used should accommodate the needs of subordinates, characteristics of the tasks the unit performs, and critical strategy-related requirements (such as time pressure, confidentiality, control, and flexibility) in the implementation phase. If the choice of style is a conscious decision, the manager must be certain that he or she is capable of leading in that manner. If the manger is not comfortable with the necessary style, or in the case where a conscious decision is not made, the top management must decide whether the importance of a specific style of leadership in effective strategy implementation necessitates a change in the management of that particular organizational unit. And it is important to recognize that leadership style is intertwined with organizational structure and the tone of the chosen strategy in influencing organizational climate. Thus, structure and the tone of strategy are important considerations in choosing a leadership style.

Organizational control systems

The purpose of organizational control systems is to guide, monitor, and evaluate progress toward the srategy's objectives. While functional strategies can offer detailed guides to action, more is required to ensure their use. And organizational structure, while effectively arranging intraorganization activities, does not guarantee day-to-day compliance with necessary standards of performance. The arena of organizational action is comprised of individuals and subunits of the firm, all of which have somewhat divergent perceptions of just what must be done to contribute to organizational, unit, and personal objectives. Their performance cannot be left to change. Rather,

[12] Arthur A. Thompson and A. J. Strickland, *Strategy and Policy: Concepts and Cases*, (Plano, Tex.: Business Publications, 1981) p. 188.

effective strategy implementation logically requires control systems that monitor, evaluate, and adjust performance.

To provide an effective strategy implementation tool, control systems must incorporate standards of performance, measurement of performance, comparison/evaluation of performance, and the impetus for corrective action. Control systems should incorporate these components in order to program the use of the firm's financial, human, and physical resources for effective strategy execution. Now let's look more specifically at some typical control systems. Figure 10-8 identifies several control mechanisms, as well as their focus, and the resources they seek to control.

figure 10-8
Organizational control systems

Resource to be controled	*Typical mechanism for control*	*Focus of the control system*
Financial	Sales budgeting	Realistic projection of revenues over time
	Capital budgeting	Effective implementation of capital investment decisions
	Expenditure budgeting	Cost control and cash management
Physical	Capital budgeting	Scheduling and procurement and/or divestiture of fixed assets
	Expenditure budgeting	Managing costs associated with the use of physical assets
	Scheduling	Timely and productive use of physical assets
Human	Expenditure budgeting	Control of personnel expenses and overhead costs
	Scheduling (human resource budgeting)	Scheduling the use of specialized human resources
	Rewards and sanctions	Motivated use of human resources

Budgeting systems

The forerunner of strategic planning systems was the budgetary process. Capital budgeting in particular provided the means for resource allocation decisions. With the growing use of the strategic management process, resource allocation decisions are based on strategic assessment and priorities, not solely on capital budgeting procedures.[13] Yet capital and expenditure budgeting, as well as sales budgeting, remain important control mechanisms in strategy implementation.

A budget is simply a resource allocation plan. Historically, budgets were treated as devices for limiting expenditures. Currently, budgets are viewed as tools for obtaining the most profitable and productive use of the com-

[13] Peter Lorange, *Corporate Planning* (Englewood Cliffs, N.J.: Prentice-Hall, 1980), p. 155.

pany's resources.[14] Budgeting cuts across all organizational resources—financial, physical, and human—as a tool for controlling their use. Budgets are typically developed for one-year time periods, but budgets covering from one month to five years are not uncommon.

Budgets require a set of performance or resource-utilization standards. But to enhance strategy implementation, the budget must be more than a set of standards or targets. Since the set of standards is in reality a detailed extrapolation of the firm's broader objectives, the budget must be an actively used tool for monitoring and evaluating performance with reference to the previously established standards. Most firms employ a budgeting system, not a singular budget, in controlling strategy implementation. Figure 10–9 represents a typical budgeting system for a manufacturing business. A budgeting system incorporates a series of different budgets fitted to the organization's unique characteristics. Since organizations differ so will their budgets. Yet, most firms include three general types of budgets—capital, sales, and expenditure budgets—in their budgetary control system.

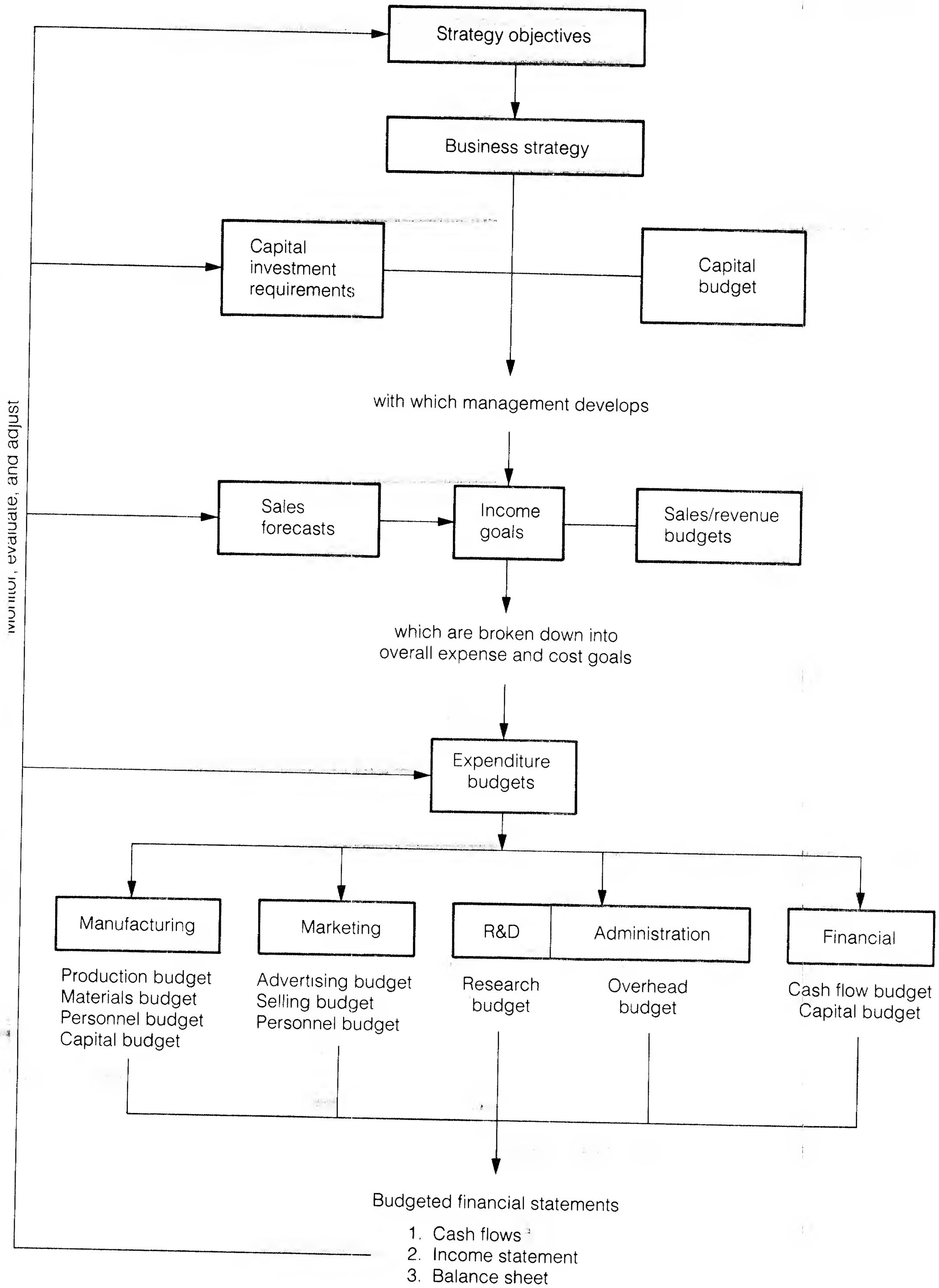
Sales budgets. Viewing the firm as a generator and user of funds, the receipt of sales revenue is a critical first step. Most firms employ some form of sales/revenue budget to monitor their sales projections (or expectations), since this is a key foundation to support the chosen strategy. It provides important information for the daily management of financial resources and key feedback as to whether the strategy is working. Whether or not it is based on sophisticated sales forecasts, the sales budget is strongly linked to past sales patterns. For example, most hotel/motel operators place intense emphasis on daily revenue compared to the same day last year as a monitor of operational effectiveness.

Sales budgets are particularly important in seasonal businesses where cash flow management is extremely critical. As a tool for the control of strategy implementation, sales budgets provide an early warning system about the effectiveness of the firm's strategy. And if the deviation is considerably below or above expectations, this budgetary tool should initiate managerial action to adjust the firm's operational or strategic posture.

Capital budgets. For most of you the phrase "capital budgeting" will conjure up memories of net present value, discounted cash flow, risk-adjusted discount rate, or numerous other techniques for evaluating capital investment decisions which you covered in a recent finance course. These are important techniques, but our concern here is with the budgetary tool to be used to implement the capital investment decisions once they have been made. We use the term *capital budget* to identify the mechanism for allocating financial resources in the implementation of major capital investment decisions.

[14] J. F. Weston, and E. F. Brigham, *Essentials of Managerial Finance* (Hinsdale, Ill.: Dryden Press, 1977), p. 116.

figure 10-9
A typical budgeting system for business-level strategy



To support their strategic choice, many firms require significant capital investment or divestiture. A firm committed to a strong growth strategy may require additional capacity or facilities to support increased sales. On the other hand, a firm that is seeking retrenchment may need to divest itself of major parts of its current operations to reach a desired activity level. In both cases, the firm is concerned with the management of significant financial resources, probably over an extended time period. To control this effectively, a capital budget which carefully plans the acquisition and expenditure of funds, as well as the timing, is essential.

Capital budgeting impacts the use of both financial and physical resources in implementing the firm's strategy. Tied in with capital investment decisions and the subsequent capital budget are the operating plans, schedules, and budgets of operational subunits, such as production and/or marketing, to accommodate the acquisition or divestiture of operating capacity. Thus, if the capital investment decisions are poorly conceived or poorly implemented, performance can suffer throughout the organization. In the extreme case, particularly considering the financial dimension, the firm's very existence could be threatened. Clearly, the capital budget is an important tool in the implementation and control of the capital investment requirements of a firm's strategic choice.

Expenditure budgets. Numerous expense/cost budgets will be necessary to add budgetary control to the implementation of strategy in various operating units of the firm. A budget of expenditures for each functional unit and similar budgets for subfunctional activities can guide and control unit/individual execution of strategy with a greater liklihood of profitable performance. For example, a firm might have an expenditure budget for the marketing department as well as another expenditure budget for advertising activities.

Dollar variables will predominate in such budgets, occasionally supplemented by nondollar measures of physical activity levels that provide the basis for the budget.[15] For example, a production budget might include standards for expenditures as well as accompanying standards for output level or productivity. These nondollar variables might also include targets or milestones that provide evidence of necessary progress toward particular strategic programs.

The purpose of the expenditure or operating budgets is to provide concrete standards against which operational costs and activities can be monitored and, if necessary, adjusted to maintain effective strategy execution. The expenditure budget is perhaps the most common budgetary tool in strategy implementation. If its standards are soundly linked to strategic objectives, then it can provide an effective communication link between top management and operating managers about what is necessary for a strategy

[15] Lorange, *Corporate Planning,* p. 158.

to succeed. It provides another warning system to alert management to problems in the firm's strategy.

The budgeting system (see Figure 10–9) provides an integrated picture of the firm's operation as a whole. A production decision to alter the level of work in process inventories or a marketing decision to change the sales organization procedures can be traced through the entire budget system to show its effect on the firm's overall performance. The budgeting system is thus a most important tool for the control of strategy implementation.

Scheduling

A key factor in the success of a strategy is often timing. Simply stated, strategic success means being at the right place and doing the right things at the right time. If a strategy is to work, the timing of its implementation must be carefully planned and controlled. And this must be done by those aware of strategic direction. Otherwise, subtle strategic shifts in past operating practices may not be initiated.

At the higher level of corporate- or business-level strategy, timing can be critical in relation to product/market evolution. Hofer and Abel have suggested that there are "strategic windows" in many industries (product/markets), that is, limited periods of time during which a firm may successfully adopt and implement a completely new strategy.[16] Thus, timing would appear critical in a firm that is radically changing its strategy. And scheduling is a useful tool to control the timing of activities and resource deployments in the implementation of a new strategy.

Scheduling is simply a planning tool for allocating the use of a time-constrained resource or sequencing interdependent activities. The success of strategy implementation is quite dependent on both. So scheduling offers a mechanism with which to plan for, monitor, and control these dependencies. For example, a firm committed to a vertical integration strategy must carefully absorb expanded operations within its existing core. Such expansion, whether it is forward or backward integration, will require numerous changes in the operational practices of some of the firm's organizational units. Scheduling through techniques like the critical path method (CPM) and program evaluation and review technique (PERT) can aid and control the effective introduction of this new organizational unit into the firm's operating structure. Coors Brewery, for example, made the decision in early 1970 to integrate backwards by producing its own beer cans. The successful execution of this strategy was aided by a comprehensive, two-year schedule of actions and targets to incorporate self-manufacture of beer cans and bottles into the product chain. Major changes in purchasing, production scheduling, machinery, and production systems were but a few of the critical

[16] Hofer, et al., *Strategic Management,* p. 17; and Derek F. Abell, 'Strategic Windows," *Journal of Marketing,* July 1978.

operating areas which Coors' scheduling efforts sought to accommodate and control.

The use of critical managers and other key human resources are often major determinants of the success of strategic programs. A diversified firm may have numerous business units and/or strategic projects in need of the services of a limited group of key managers. Obviously, for the implementation of strategy to have the greatest chance of succeeding, these managerial resources must be carefully allocated. Scheduling offers one tool to plan and subsequently control this resource. This can occur with other human resources, particularly those in short supply. Since the decontrol of oil prices, major oil firms have greatly expanded their search for new domestic supplies. The result has been a scarcity of competent petroleum geologists within the industry. This has caused incredible escalation in the compensation of petroleum geologists as oil firms fight to retain such critical expertise. It has also necessitated careful scheduling or petroleum geologist budgeting within most oil firms to carefully allocate this valuable human resource across numerous exploration projects critical to the success of the firm's strategy.

Like budgeting, scheduling is an important tool at virtually every level of the organization to control the execution of a chosen strategy. Whenever time-constrained resources or interdependent activities exist, from business units to a district sales office, scheduling can provide identifiable targets to guide and control implementation.

Rewards and sanctions

The effective implementation of strategy ultimately depends on individual organizational members, particularly key managers. The motivation and rewarding of good performance by individuals and organizational units are key ingredients of effective strategy implementation. And while positive reinforcements are given primary emphasis, sanctions or negative reinforcements are important tools for controlling and adjusting poor performance. Motivating and controlling individual efforts, particularly managerial personnel, toward the execution of strategy is sought through the firm's reward-sanction mechanisms—compensation, raises, bonuses, stock appreciation rights, incentives, benefits, promotions, demotions, recognition, praise, criticism, more (or less) responsibility, group norms, performance appraisal, tension, and fear. These mechanisms are both positive and negative as well as short run and long run in nature.

The important task of these control mechanisms is to align personal and subunit actions and objectives with the objectives and needs of the firm's strategy. This is not an easy task. Reward-sanction structures to control strategy execution vary greatly across different firms in terms of how they use these mechanisms. For example, Harold Geneen, former CEO of ITT, purportedly used an interesting combination of money (compensation and

incentives), tension (strict accountability for results), and fear to control individual manager's efforts toward strategy implementation.

> Geneen provides his managers with enough incentives to make them tolerate the system. Salaries all the way through ITT are higher than average—Geneen reckons 10 percent higher—so that few people can leave without taking a drop. As one employee put it: "We're all paid just a bit more than we think we're worth." At the very top, where the demands are greatest, the salaries and stock options are sufficient to compensate for the rigors. As someone said, "He's got them by their limousines."
>
> Having bound his men to him with chains of gold, Geneen can induce the tension that drives the machine. "The key to the system," one of his men explained, "is the profit forecast. Once the forecast has been gone over, revised, and agreed on, the managing director has a personal commitment to Geneen to carry it out. That's how he produces the tension on which the success depends." The tension goes through the company, inducing ambition, perhaps exhilaration, but always with some sense of fear: what happens if the target is missed?[17]

BIC Pen Company takes a different approach. Its reward structure uses incentive systems, wide latitude for operating managers, and clearly specified objectives to motivate and control individual initiative. All employees are invited to participate in a stock purchase plan whereby up to 10 percent of their salary can be used to purchase stock at a 10 percent discount from the market price. Functional managers are given wide reign in operational decisions while being strictly accountable for results. The director of manufacturing, for example, is free to spend up to $500,000 for a cost-saving machine, as long as profit margin objectives are maintained. Commenting on his approach to rewarding executives, BIC's president, Robert Adler, has said:

> We have a unique bonus system which I'm sure the Harvard Business School would think is crazy. Each year I take a percentage of profits before tax and give 40 percent to sales, 40 percent to manufacturing, and 20 percent to the treasurer to be divided up among executives in each area. Each department head keeps some for himself and gives the rest away. We never want bonuses to be thought of as salaries because they would lose their effect. So we change the bonus day each year so that it always comes as a pleasant surprise, something to look forward to.[18]

These two examples highlight several generalizations about the use of rewards and sanctions to control individuals, and particularly managers, in strategy execution. Financial incentives are important reward mechanisms. They are particularly useful in controlling performance when they are directly linked to specific activities and results. Intrinsic, nonfinancial re-

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[17] Anthony Sampson, *The Sovereign State of ITT* (New York: Steing & Day, 1973), p. 132.

[18] C. R. Christensen, K. R. Andrews, and J. L. Bower, *Business Policy: Text and Cases* (Homewood, Ill.: Richard D. Irwin, 1978), p. 318.

wards, such as flexibility and autonomy in the job and visible control over performance, are important managerial motivators. And negative sanctions, such as the withholding of financial and intrinsic rewards or the tensions emanating from possible consequences of substandard performance, are necessary ingredients to direct and control managers' efforts.

In linking rewards and sanctions to strategically important activities and results, one final dimension must be mentioned—the time horizon on which rewards are based. Numerous authors and business leaders have expressed concern with incentive systems based on short-term (typically annual) performance. They fear that short-term oriented reward structures can result in actions and decisions that undermine the long-term position of the firm. A marketing director that is rewarded based on the cost effectiveness and sales generated by the marketing staff might place significantly greater emphasis on established distribution channels rather than inefficient nurturing and development of channels which the firm has not previously used. A reward system based on maximizing current profitability can potentially shortchange the future in terms of current investments (time, people, and money) from which the primary return will be in the future.[19] If the firm's grand strategy seeks growth through, among other means, horizontal integration of current products into new channels and markets, the reward structure could be directing the manager's efforts in a way that penalizes the ultimate success of the strategy. And the marketing director, having performed notably within the current reward structure, may have moved on to other responsibilities before the shortcomings emerge.

Thus, in recognizing the strategy's time horizon, a good reward system should provide payoffs that control the creation of potential future performance as well as for current performance.[20] Some firms are experimenting with a management reward system tied to three-year cycles of strategy implementation activity. Figure 10–10 illustrates how this might work. It essentially sets into motion annual bonuses (or other financial incentives) which are based on creating the desired future performance. By having a manager's bonus linked to future outcomes of current strategy execution, the manager's incentive payoff will follow the individual in movement to other positions. Thus, the system offers one reward-sanction technique for controlling the balance of current and future emphasis in managers' strategy execution decisions and actions.

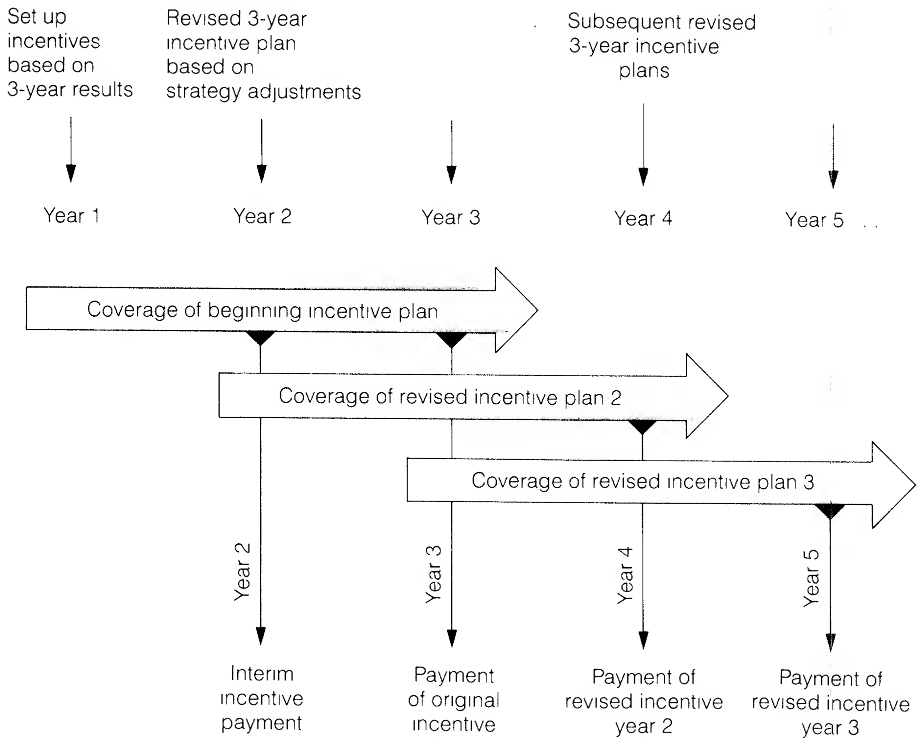
Another approach, suggested by Hofer and Davoust, advocates balancing the present/future focus of compensation bonuses for business-level managers based on the essence of the unit's strategy.[21] What they suggest is

[19] W. R. King and D. I. Cleland, *Strategic Planning and Policy* (New York: Van Nostrand Reinhold, 1978), p. 364.

[20] Ibid., p. 364.

[21] C. W. Hofer and M. J. Davoust, *Successful Strategic Management* (Chicago: A. T. Kearney, 1977), p. 46.

figure 10–10
Annualized, long-term oriented incentive system



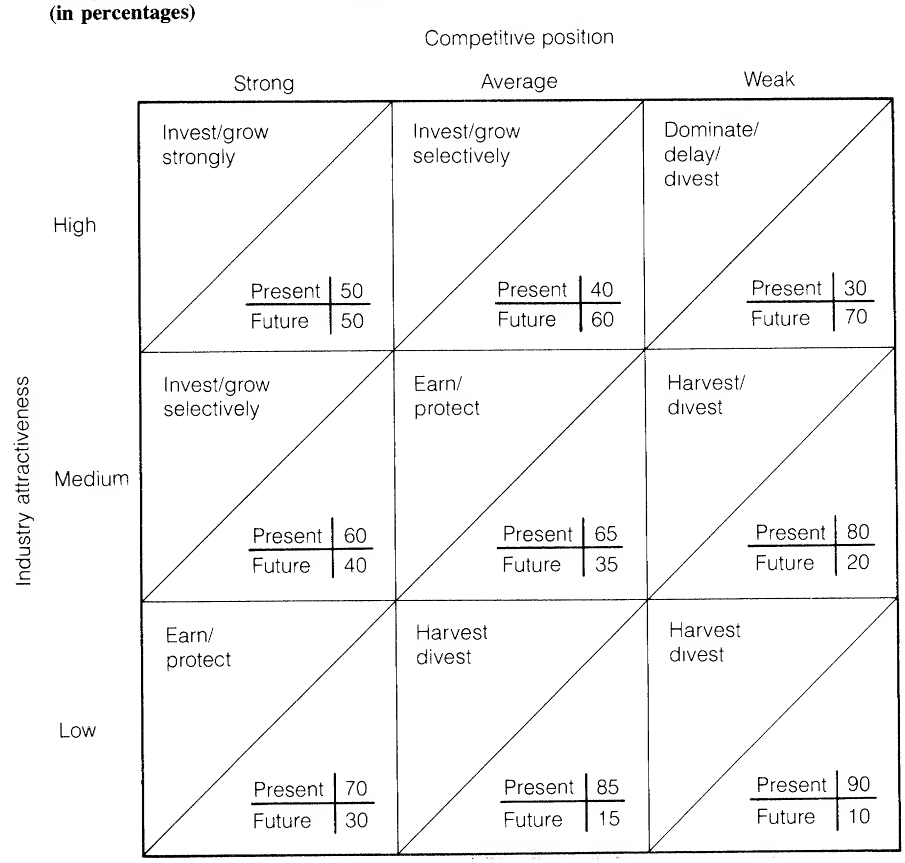
shown in Figure 10–11. The figure supports the notion that time horizon of the strategy, its realistic payoff date, should directly influence the trade-off between present versus future focus in executive compensation For use as a control mechanism, executive reward systems should be based more on current performance in stable growth or retrenchment strategies and more on future performance when rapid growth is a reasonable possibility within the industry.

Strategic control: Review and evaluation of strategy

The last phase of the strategic management process is review and evaluation. During this phase the firm's top management seeks to determine if their chosen strategy as it has been implemented is meeting the objectives of the firm.

As the strategy is implemented, organizational control systems—budgets, scheduling, rewards, and sanctions—help ensure that the strategy as originally conceived is systematically implemented. Monitoring and controlling initial strategy implementation, while critical in the effective execution of

figure 10–11
The present/future focus of compensation bonuses for business-level general managers (in percentages)



Source: Adapted from C. W. Hofer and M. J. Davoust, *Successful Strategic Management* (Chicago, Ill.: A. T. Kearney, 1977), p. 46.

strategy, is not all that is necessary to facilitate strategic success. Most strategies require long lead times before their impact is fully realized. Consequently, while the previously discussed organizational control systems monitor certain specific actions associated with the implementation of a new strategy, top management will not usually be able to tell until some time after the occurrence of the action whether it had the desired strategic impact.[22] Thus, top management must be concerned with a broader control horizon, when focusing on what we call *strategic control,* in which they review and evaluate the chosen strategy. In the review and evaluation of strategy, top management must focus on both qualitative and quantitative dimensions.

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[22] Hofer et al., *Strategic Management,* p. 23.

The qualitative dimension of strategy review and evaluation seeks to confirm or refute critical assumptions on which the strategy is based. Richard Rumelt proposes four criteria with which to review and evaluate the critical assumptions of the current strategy:

Consistency. The strategy must not present mutually inconsistent goals and policies.

Consonance. The strategy must represent an adaptive response to the external environment and to the critical changes occurring within it.

Advantage. The strategy must provide for the creation and/or maintenance of a competitive advantage in the selected area of activity.

Feasibility. The strategy must neither overtax available resources nor create unsolvable subproblems.[23]

Thus, the qualitative dimension of review and evaluation seeks to determine if the strategy is still consistent with environmental conditions and internal capabilities. Is the strategy still consistent with changes in the environment? Have the competitive advantages, on which the strategy was conceptualized, materialized? Has the manner in which the strategy was implemented created any problems or unusual advantages? Top managements' conclusions may suggest adjustments in the current strategy. Nevertheless, this qualitative evaluation provides important feedback into the formulation phase of the ongoing strategic management process.

The quantitative dimension of strategy review and evaluation seeks to measure the impact of the strategy on specific criteria relevant to the long-term objectives of the firm. Figure 10–12 provides a list of typical quantitative measures that might be used. Review and evaluation of a strategy's effectiveness usually compares the chosen measure with previously established targets, the firm's historical performance, and the past/present performance of its competitors. The key measures which top management uses will vary with the strategy. For example, sales growth and market share were two primary measures employed by Miller Beer executives in evaluating the effectiveness of their aggressive growth strategy in the 1970s.

figure 10–12
Typical strategy evaluation measures

Sales growth	Return on equity
Output growth	Return on investment
Asset growth	Sales/profit per employee
Market share	Gross margin
Stock price	Production costs and efficiency
Net profit	Employee satisfaction
Return on sales	Value added
Earnings per share	

[23] Richard Rumelt, "The Evaluation of Business Strategy," in *Strategic Management and Business Policy* ed. William F. Glueck (New York: McGraw-Hill, 1980), p. 360.

Winnebago management, pursuing a retrenchment strategy since 1974, has been extremely concerned with efficiency (profitability) and effective asset utilization (and less concerned with market share) as they have sought to stabilize their position in the depressed recreation vehicle industry.

strategy in action, 10-4
Strategic Review and Evaluation at Texaco

None of the major oil companies was fully prepared for the upheaval of the 1970s, when crude oil surpluses swung into shortages, producing countries expropriated supplies, prices soared, and oil became a politicized commodity in consuming as well as in producing countries. But for Texaco Inc., once the most successful of the Seven Sisters, the 1970s were a near disaster. Two decades earlier, Texaco had set in place a long-range strategy centered on a key assumption that crude oil supplies would remain cheap and plentiful forever.

From the assumption came functional strategies. Exploration was minimized while enormous efforts went into acquiring strong market positions in all 50 states. To service those markets, Texaco built a network of regional refineries across the United States and invested in a huge central refinery in Trinidad to run its foreign crude and service foreign and domestic markets. Those integrated strategies worked so well for so long that even the thought of changing them was heretical to management.

But when the underpinnings of its strategy collapsed with the Arab oil embargo of 1973, Texaco faced its changed environment with one of the weakest exploration programs, one of the largest—and least efficient—refining and marketing systems, and with almost no diversification to cushion the shock. Even worse, because its management was centralized and introverted, the company was the least responsive and most inflexible of its peers.

Because of all that, Texaco is only now rebounding from the debacle. Ironically, the recovery is being aided by the inverse of Texaco's basic premise. The fact that oil is in short supply and increasingly expensive has revalued Texaco's remaining assets and brought it higher prices than ever.

But the experience has shaken Texaco to its core. Not only has it been compelled to view its universe differently, but it has been forced to develop an entirely new long-range plan, based on radically altered assumptions. They envision far narrower markets and an intensive, expensive search for new supplies. They also include the inexorable recognition that Texaco must begin to turn from its traditional business within the next

strategy in action, 10–4 ***(concluded)***

decade, and that it must direct its resources to areas in which Texaco—and other companies—have little experience and less expertise. Even its present businesses must be managed differently.

Long time observers of Texaco note that the company got in trouble not because it had emphasized refining and marketing at the expense of exploration and production. Many companies had done that, and Texaco more than any other had prospered with that strategy. Texaco's failing was that it had built up so much inertia in its system that it could not move off the course it had been following. "Texaco was several years late in seeing the handwriting on the wall, and even when it saw the changes, it was married to its old system," says a planner for another oil company.

Source: Based on the article "Texaco: Restoring Luster to the Star," from the December 22, 1980 issue of *Business Week*.

The choice of both quantitative and qualitative criteria to facilitate strategic control is a difficult task. While choosing measures that reflect the strategy's objectives and impact sounds simple enough, it is not necessarily so easy in practice. With multiple objectives, many of which are stated in rather general terms, achieving top-management consensus on the best evaluative criteria is unlikely. Multiple criteria, from both the qualitative and quantitative dimensions, are usually necessary. Even then, the question of which are most important (particularly when they produce contrary feedback about the strategy's impact) can be a difficult issue. This simply reinforces the importance of careful choice of review and evaluation measures as they relate back to the specific long-term objectives of the grand strategy. Equally important, measures must provide feedback to strategists about the firm's progress toward its overriding goals of profitability, survival, and growth.

In addition to the choice of evaluative criteria, the flexibility and ability to make strategic changes is not often an easy consequence of strategic review and evaluation. Most strategic decisions, once implemented, are very difficult to quickly reverse. Major capital investments, expansion of product lines, or changes in marketing channels which turn out to have been wrong will often have to be lived with for several years before it is possible to correct the mistake.

While choice of evaluative measures and the ability for rapid response are difficult aspects of review and evaluation, they do not detract from the overall importance of this phase of the strategic management process. Systematic review and evaluation keeps top management close to the pulse of the strategy. It provides important feedback, over time, for the adjustment and/or reformulation of a firm's strategy.

The review process can force discussion on how current plans will overcome recent results that are not consistent with strategic direction: "Last

year you said you were headed into new market channels. Why aren't we moving in that direction? What action is to be taken?"

To make the review and evaluation phase more responsive, an increasing number of firms have incorporated strategic contingency plans into their strategic management process. Triggered by major changes in predetermined measures or factors, previously developed contingency plans will hasten top-management's ability to swiftly respond if some of the major underlying assumptions of the chosen strategy turn out to be wrong. In addition to preparing a rapid response to negative conditions, contingency plans can be useful in preparing rapid response to capitalize on circumstances that are better than expected.

With or without contingency plans, review and evaluation for strategic control purposes is still more art than science. It requires management motivation, intuition, and sensitivity to various qualitative dimensions of the interface between the firm and its environment. Though not an exact science, review and evaluation provide the feedback essential to management of strategy. And firms that systematically review and evaluate the results of the implemented strategy could logically be expected to be more effective than those which do not.

Summary

Implementation of a firm's strategy is a critical phase in the strategic management process. It is here that thought is translated into organizational action. This chapter presents four categories of managerial/organizational tools that provide the mechanisms for implementing the firm's grand strategy: (1) functional strategies, (2) organizational structure, (3) organizational leadership and (4) organizational control systems.

Functional strategies provide a critical link between strategy formulation and strategy implementation. As detailed guides to action, they provide a test of the consistency between functional requirements of the grand strategy and functional capabilities of the firm or unit. As the first concrete interpretation of the grand strategy for operating managers, functional strategies are pivotal implementation tools for managing strategy execution at the operating (action) level of the firm.

Organizational structure provides another important tool for strategy implementation. Structure provides the means for subdividing organizational tasks to achieve the benefits of specialization and division of labor. At the same time, structure provides the means for integrating and coordinating the subparts into a cohesive, effective organization. This chapter presented five types of organizational structure. Each have their pros and cons, and the choice of structure should be based on the needs of the firm's strategy. As firms move through different stages of development, with correspondingly different strategies, research has shown a consistent pattern of changing organizational structure. However, because of inertia, relative costs and

organizational politics, structural change does not immediately accompany a change in strategy until after the firm's performance has declined.

While structure is important, it provides only the framework for organizational action. Organizational leadership is an important tool for breathing life into this framework. The CEO occupies a critical role in organizational leadership by providing the impetus for strategy execution and as the creator of the climate for action. Assignment of key managers is another leadership consideration of major importance in strategy implementation. Matching the characteristics of individual managers with the needs of component strategies will enhance strategic success. Likewise, the managerial leadership style must be compatible both with the needs of the strategy regarding various organizational units and with the characteristics of unit members.

Another critical dimension of strategy implementation is the control of internal strategy execution. This chapter discussed three types of organization control systems—budgets, scheduling, rewards and sanctions—that provide important implementation mechanisms for controlling the use of the financial, physical, and human resources of the firm.

While the implementation and control of the chosen strategy is a critical phase in effective strategic management, one final component helps achieve long-term success. This chapter discussed the review and evaluation phase as a critical feedback mechanism for the adjustment and redesign of corporate strategy. Focusing on environmental changes and actual implementation results, this often underemphasized phase seeks to ensure that the basic premise of a firm's strategy remains consistent with its competitive environment.

As the action phase of strategic management, strategy implementation evokes the natural reaction of being the most important. In this regard, we urge caution. Although formulation and implementation are characteristically different activities, they are inextricably interdependent in achieving long-term success. There is no way to effectively compensate in strategy implementation for a strategy that was incorrectly assessed or not considered at all. Likewise, the most astutely formulated strategy cannot compensate for ineffective use of the tools of implementation and control.

Questions for discussion

1. What is strategy implementation? How does it differ from strategy formulation? Which is most important?
2. What key structural considerations must be incorporated into strategy implementation? Why does structural change often lag behind a change in strategy?
3. Which structure is most appropriate for successful strategy implementation? Explain how stage of development affects your answer?
4. Why is leadership an important tool in strategy implementation? Compare the role of leadership at Texaco and Shell.

5. Describe the key tools for control of strategy implementation. What do they control?
6. Why are strategists seeking reward systems that are similar to Figure 10-10? What are the advantages and disadvantages of such a system?
7. How is strategic control different from the regular tools for control of strategy implementation?

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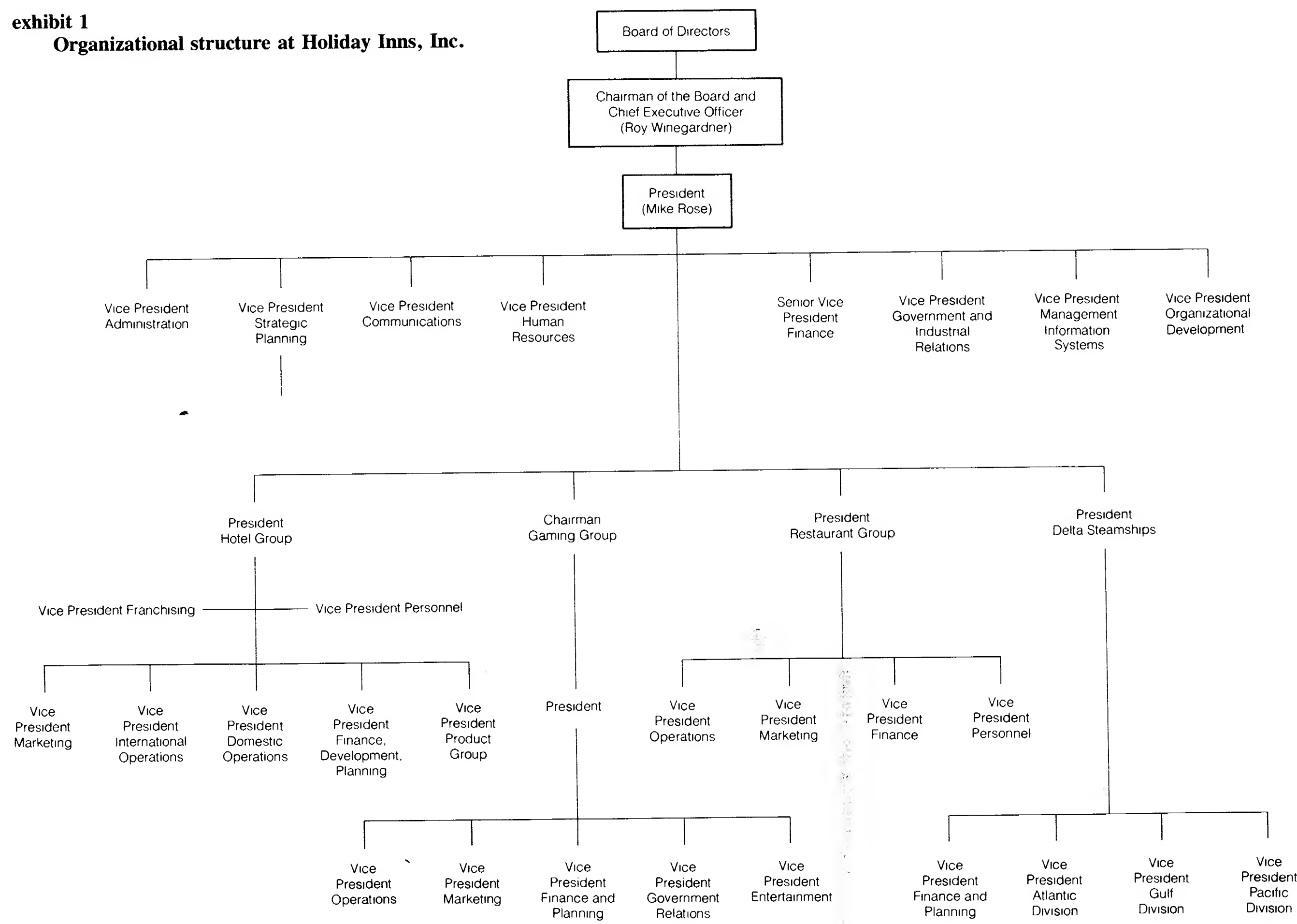
chapter 10 cohesion case

Strategy implementation and control at Holiday Inns, Inc.

What tools has Holiday Inns used to implement its strategy? Clearly a wide range of implementation tools are being utilized throughout the Holiday Inns enterprise. Because they are so numerous, we will selectively illustrate these tools at the corporate level and within one business group—hotels.

Corporate-level implementation tools. A key implementation tool at Holiday Inns, Inc. is its *organizational structure.* Exhibit 1 provides an abbreviated look at the organizational structure of Holiday Inns, Inc. As you can see, Holiday Inns has a divisional structure with four rather autonomous business groups. This clearly reflects the needs of its corporate diversification strategy by providing each business group with its own functional sup-

exhibit 1
Organizational structure at Holiday Inns, Inc.



port and broad decision-making capability. Second, the formerly separate products group has been reorganized within the hotel group. This clearly reflects the strategy of retrenchment within the products group to limit it primarily to a service role for the hotel group's furnishing and equipment needs. Finally, Delta Steamship has been organized as a fully independent and autonomous unit. This distinguishes Delta from the hospitality businesses and facilitates rapid divestiture should Holiday Inns find the right opportunity to do so.

Assignment of key managers reflects another deliberate choice at the corporate level to effectively implement Holiday Inns' diversification strategy. As you will see in the Holiday Inns, Inc. (B) case, Holiday Inns' three nonhotel divisions have as their presidents, the former CEOs at Harrah's, Perkins, and Delta, respectively. Instead of putting a Holiday Inns-trained executive in charge, corporate management deliberately chose to maintain an autonomy and leadership climate that reflects the unique needs within these new groups. Finally, reflecting a portfolio strategy that emphasizes casinos as the key growth area, the gaming group is the only business group other than hotels to have representation on the board of directors and corporate management level.

Business-level implementation tools. Obviously, with four distinct business groups, there are a wide range of implementation tools in effect across the business level. Rather than discuss all of these, we will describe three typical implementation tools within the hotel group: *expenditure budgeting, quality control,* and *incentive bonuses.*

Holiday Inns has an expenditure budgeting system, which is called operations management systems (OMS), that has been implemented at the individual inn level. The purpose of this system is to monitor and control profitability by providing weekly budgets for the use of hotel resources that reflect the cyclical nature of occupancy patterns throughout the year. This OMS budget projects staff scheduling, energy control, departmental (inn, restaurant, and lounge) expenditures and usage, inventory control, and quality assurance needs on each successive week throughout the year to help control profitability and the level of service the customer expects.

The hotel group puts major emphasis on its quality control system to ensure that the strategy of standardized, high-quality accommodations is being implemented. The heart of the quality control system is 25 full-time inspectors who travel over 1 million miles during the year performing over 4,300 property reviews. Most properties are inspected three times a year on an unannounced basis during which some 1,100 different items are checked. Hotels failing to meet standards (after two inspections) are removed from the system.

Holiday Inns' reward system is multifaceted in its approach to guiding desired strategy implementation. First, the hotel group monitors industry-wide compensation packages to ensure that Holiday Inns' basic package is

comparable to or greater than the industry norm. They also provide an incentive cash bonus plan for officers and key employees whereby these individuals can earn up to 81 percent of their annual salary if implementation targets are met. Recognizing the key corporate objective of enhancing stock value, Holiday Inns provides key management personnel with long-term cash or stock bonuses based on appreciation in the price of the company's publicly traded stock.

Introduction to the alternate cohesion cases: Congress Motel and Brown's Overnite Trailer Park

This section begins a series of nine Cohesion Case sections—with each section related to a chapter in this book. The purpose of this series is to illustrate each chapter discussion using an existing business enterprise. To ensure continuity in illustrating chapter material, the nine sections will focus on the same business. This business is called Congress Motel.

Congress Motel is a small business located in southwest Georgia that provides motel and campground accommodations to travelers on Interstate 75. It was selected for this alternate Cohesion Case series because it offers a simple, easily comprehendable business entity. As a result, it should facilitate maximum focus on the application of text material to a business enterprise and avoid wasted energy on simply trying to understand what the business is about.

The remainder of this series provides an analysis of the material in each chapter as applied to Congress Motel. At this point, you should read the case study entitled "Congress Motel and Brown's Overnite Trailer Park," which follows this introductory section. The case study provides the basis for understanding the remaining sections in this Cohesion Case series. You should read this case material thoroughly to gain a basic familiarity with Congress Motel. As the remaining Cohesion Case sections are covered, you are encouraged to refer back to the case study, occasionally rereading the material. Doing this should help you understand just how the components of strategic management, discussed in each chapter, are being applied to Congress Motel in the respective Cohesion Case sections.

alternate cohesion case

Congress Motel and Brown's Overnite Trailer Park

1 The lure of steady profits from a small motel operation has occasionally led people to enter the motel business when they found major highways being built adjacent to their land. Typically, these independent owner-operators constructed 20 to 30-room units, which are classified as mom-and-pop operations. Congress Motel is one such operation. Located outside of the city of Ashburn in southwest Georgia, it was built in 1966 by a local farmer on land he owned adjacent to the new interstate highway.

2 The completion of the interstate network in the 1960s and 1970s had a major impact on the motel industry. With the relative prosperity of the American public and their increasing leisure time, the United States witnessed a virtual explosion in the proliferation of motel chains. By franchising (Holiday Inns, Ramada Inns, Days Inns, etc.) and systematic reservation networks (Best Western and Quality Inns, for example), standardized motel accommodations suddenly blanketed the interstate highway network. In 1970, Holiday Inns claimed that "a new Holiday Inn room was being built . . . every 15 minutes." With strong financial capacities, sophisticated reservation systems, large advertising budgets, and reasonably priced, quality accommodations, these motel chains created a challenging environment for the small, independent operations like Congress Motel.

The Browns

3 Calvin and Christine Brown have lived in southwestern Georgia since birth. Calvin Brown is 48 years old, and Christine Brown is 47; they married in 1948. Calvin Brown met Christine when she was visiting her grandparents who lived across the field from his father's farm.

4 Calvin completed high school in 1947. He received the American farmer's degree from a vocational program in Kansas City two years later. Christine Brown completed high school just prior to her marriage.

5 Brown had a farming operation for the 19 years prior to starting his motel in 1966. He still helps his father with a small farming effort and receives a \$5000-per-year rental on a 20-acre peanut allotment in his name. Christine worked for five years as a nut sorter with a local peanut company prior to the birth of her first child in 1954. The Browns have two sons (aged 24 and 22) and one daughter (aged 14). Mrs. Brown maintains household responsibilities and also assists her husband in operating the motel office.

The revised edition of this case was prepared by Richard Robinson, University of South Carolina, and Tim Mescon, Arizona State University.

exhibit 1
Congress Inn Motel

6 In 1966, with Interstate 75 being built adjacent to some of his farmland, Brown chose to enter the motel business as an alternative to a lifetime of sporadic profitability as a family farmer. With Interstate 75 promising to be a major tourist route to Florida and motels in the area relatively scarce, Brown sought to capitalize on the location of his farmland and reap the promise of steady profits with his own interstate motel. (See Exhibits 1 and 2.)

exhibit 2
Christine and Calvin Brown

Location and facilities

7 The Congress Motel is part of the South I-75 travel industry from Macon, Georgia, to the Florida line. This area reflects the same pattern of franchise dominance as experienced nationwide.

8 The South I-75 travel industry will experience a greater traffic flow (an increase of approximately 32 percent), according to the Georgia Travel Bureau. (See Exhibit 3.)

exhibit 3
Projected travel flow

	1976	*1980*	*1990*
Average daily volume (cars)	26,000	36,000	44,600
Average daily recreational/ vacation volume	8,840	12,240	14,960

9 Based on sampling procedures conducted by the Georgia Welcome Centers and information on the facilities available, Exhibit 4 offers some indications of motel and campground expectations in this South I-75 area. For example, the average motel occupancy should gradually increase, but its level in 1980 reflects an overbuilt South I-75 motel industry. On the other hand, campground construction is expected to double in an attempt to partially close a large gap, with demand (for camping facilities) exceeding supply.

exhibit 4
Welcome Center projections

	1980	*1990*
Number of motel rooms available	8,280	9,108
Number of cars desiring motels	6,487	7,779
Average occupancy rate at South I-75 motels	78.3%	85.4%
Number of campsites available	840	1,680
Number of vehicles desiring camping	1,469	2,244
Average occupancy rate at South I-75 campgrounds	175%	133%

10 Through the Welcome Center's survey of travelers, some additional market information on South 1-75 travelers is summarized in Exhibit 5. It suggests that South I-75 travelers are staying longer in Georgia, increasingly seeking to camp while traveling, and enjoying "outdoor-oriented" entertainment activities.

11 Congress Motel is located on the southast corner of the I-75 exit just outside Ashburn, Georgia. A large lake at the front of the property abuts the northbound exit ramp and provides an attractive setting for a

exhibit 5
South I-75 travelers

	1967	1975
A. Average number of days in Georgia		
1–2	68%	51%
3 or more	32	49

	1964–1967	1974–1975	1977–1978
B. Type of accommodations desired			
Motel	66.0%	53.0%	50.0%
Camping	1.8	10.5	12.8

C. Activities most frequently engaged in
(by frequency mentioned on surveys)
1. Going to scenic places
2. Going on picnics
3. Camping
4. Fishing

motel/campground facility. Exhibit 6 is a diagram of the interchange, and the location of competitors and other businesses.

12 The motel/campground is situated in full view of the northbound traveler; the traveler can see the property before reaching the exit. However, the southbound traveler cannot see the property until after passing the exit ramp for the southbound traffic. The front office is conveniently located to handle incoming traffic for both the motel and the campground.

13 The motel facility consists of 26 double-sized rooms built in the original (1966) brick structure. In 1967, Brown added two sets of four single units (portable trailers); they are attractively situated at the north and south ends of the original structure. These were added to accommodate the high volume of single (business) traffic in the late 1960s. (See Exhibit 7: Diagram of building and grounds.) In July 1978, there was a $15,300 balance outstanding on an SBA loan for these two four-room units. All units have a TV, air conditioning, and adequate furnishings.

14 Attempting to offer recreational facilities comparable to those of the major motel chains, Congress Motel has a swimming pool, a miniature golf course, a large lake for fishing, and picnic tables along the lake. It does not, however, have a restaurant. A truck stop restaurant was located across the street until it closed in 1975, and the closest restaurant is now a popular, local country food restaurant two miles away.

15 Concerning the lack of a restaurant, Brown said:

> We never put in a restaurant because of the overhead involved. There used to be a restaurant over there [gesturing to an abandoned gas/restaurant facility] where my guests could just walk over. They [the restaurant] left about three years ago and so have two of the three gas stations on this interchange. Now when my guests want to eat I send them to Mrs. Smith's restaurant in Sycamore, about two miles down the road.

exhibit 6
Diagram of interchange

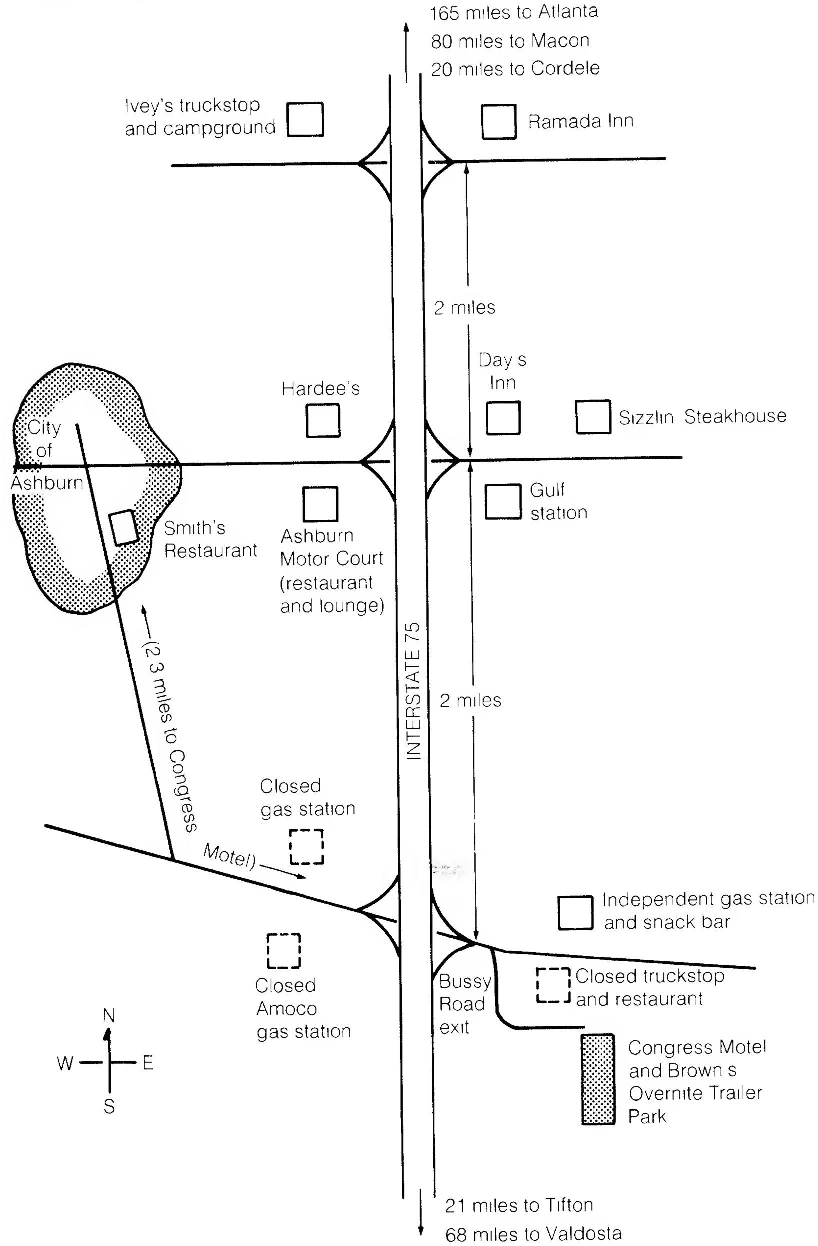
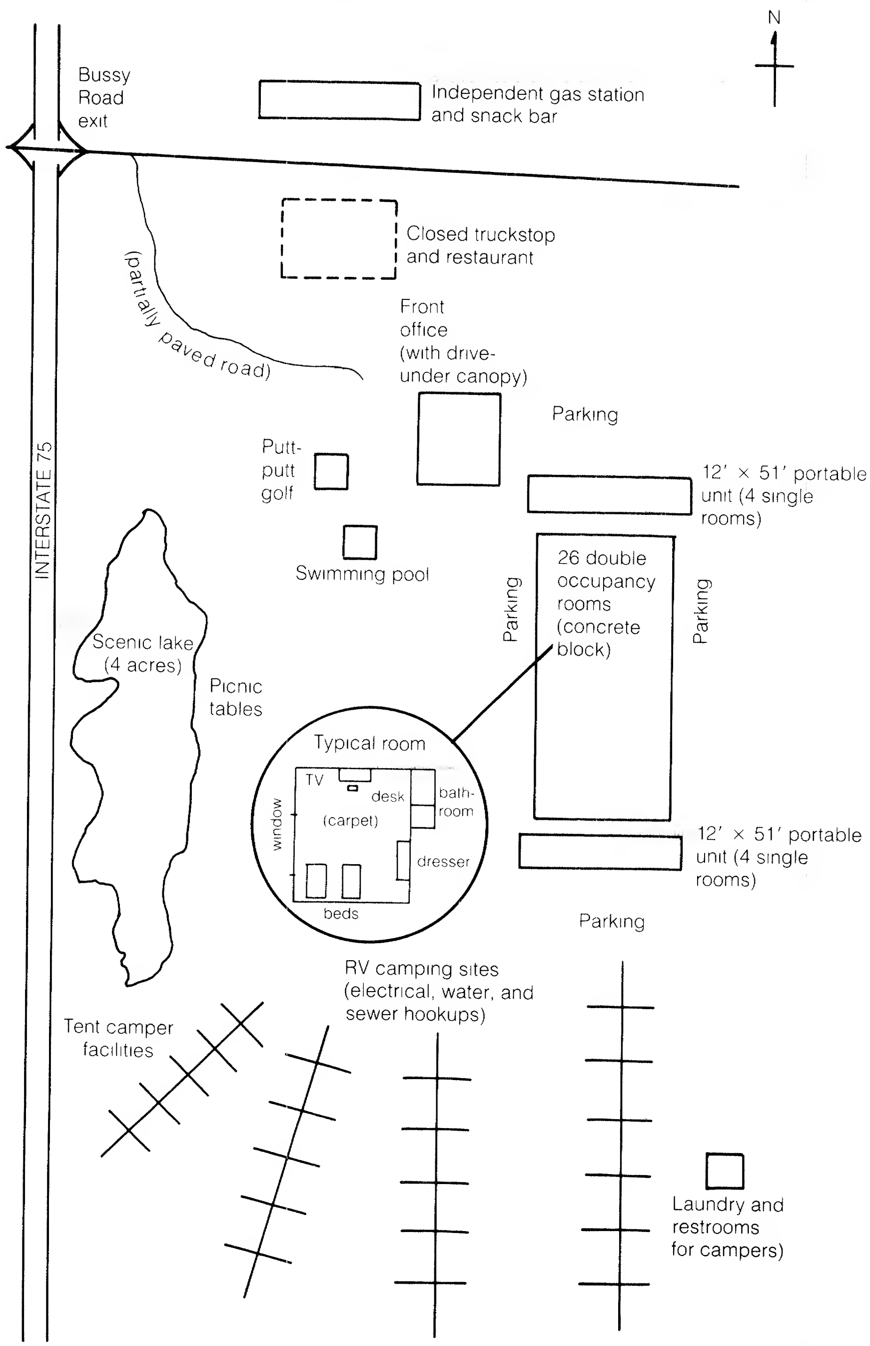


exhibit 7
Diagram of buildings and campground



16 The campground facility was developed in 1966 on land owned by Brown adjacent to the motel facility. In addition to the recreational vehicle (RV) hookups, Brown constructed a shower/restroom/laundry facility for tent campers. Commenting on the campground facility, Brown said:

> When I opened the motel, it seemed easy to add some sites for trailer campers. My family, at one time, frequently took vacations using trailer camping. For the sites, I installed sewage disposal running to the same oxidation pond used by the motel. Altogether, adding camping sites cost me only one fourth (per site) what these campground chains pay for similar site development, and that doesn't include the fact that I own the land.

17 "The campground was named Brown's Overnite Trailer Park because it would attract truckers and trailer campers as well as let the trailer campers know that hookups were available," according to Brown. Brown further indicated that this name would "identify me personally to repeat customers" and that "it could easily be painted on present billboard runners."

Marketing strategy

18 Motels located alongside interstate highways face a common, critical challenge—to get the interstate travelers' attention and encourage them to exit at the appropriate interchange and utilize the motel (or campground) facilities. The larger chains, with national advertising and name recognition, have a distinct advantage in this regard. To Brown, the key to his success in this regard centered around billboard signs, pricing strategy, and name.

19 "I tried to advertise as much as I could on my signs and even repaint them myself, when I have time, to save money," offered Brown. Continuing, Brown noted that "the highest I pay for sign rent is $210 per year. I own the signs and rent the site. Nowadays, it costs $150 a month for you to rent a billboard on I-75. Most of the chains here have to pay that price and have only five or six signs." Brown advertised the motel in AAA literature and by placing brochures in Welcome Center travel stands prior to 1974. In mid-1974 the brochures were discontinued as a cost reduction measure. Also, AAA deleted Congress Motel from its listing in late 1973 due the presence of portable rooms on the premises. Mr. Brown advertises his campground in an annual RV directory distributed nationwide.

20 Congress Motel charges the second-lowest prices of any motel between Macon and Valdosta, Georgia (Florida line). The standard rates at Congress Motel are $8 for single occupancy and $10 for double occupancy. The only lower price is $7.88 for a single. The campground charges $3 per vehicle plus 25 cents for each person over two in the party. Brown has been contacted by several campground chains (KOA, Ponderosa) on I-75; they want him to increase his rates, which are about $1 to $2.50 below competitors' rates. Brown advertises the motel prices on six of his billboard signs and the campground price on one of these signs. A Welcome Center survey indicated that the average expense for a party (one vehicle) on South I-75 for one

day in a motel or campground (1975) was $11.27 for motel accommodations and $4.51 for camping accommodations. Commenting on his prices, Brown noted:

> Prices in this area are really quite low. But I'm still lower than anyone except LaQuinta around Tifton [Georgia]. Even at my price, I only have to have about 55 percent average occupancy to break even.

21 Brown later indicated that he would keep his prices low for the foreseeable future. "That's my main advantage. I just can't seem to get enough people in here," added Brown. The average single-room rate for chain motels in the area are as follows: Holiday Inn—$14.50, Ramada Inn—$13, Day's Inn—$11.88, Ashburn Motor Court—$10.88. Commenting on competition along South I-75, Brown said:

> There have been a lot of motels built between Macon and Valdosta [Georgia] since I opened up. I've tried to keep my price low, but those Day's Inns and some budget inns have really hurt. I still get some repeats from my snowbirds from up north and Canada, but I think a lot of folks just prefer to spend the extra dollars to have a restaurant and lounge to go to. But a lot of other places are hurting. The Ashburn Motor Court up the road closed, but some Arabs bought them out and reopened it. A new Ramada Inn just north of me was built and never opened. The gas crisis just hurt me. The Amoco station and the Citgo station [on this interchange] closed which stopped people getting off here. It's a dying interchange.

22 When the motel was opened in 1966, Brown paid $7,500 for a Congress Inn franchise and operated under that name for several years. In 1972, Brown ended his franchise arrangement, feeling his business derived virtually no benefit from the 2 percent (of room revenue) franchise fee he was paying. The name was changed to Congress Motel at this time. According to Brown:

> I was throwing away money for hardly any services when I used "Congress Inn." So I just changed the "Inn" to "Motel" and quit paying. But I don't know. "Motel" seems to be out-of-date in this business. People think you're a run-down facility. And I'm beginning to think "Congress" hurts me too since it reminds people of Washington bureaucrats and Watergate. At least that's what my sign painter said.

23 Brown's camping facility seems to face an identity problem with the name Brown's Overnite Trailer Park. In the spring issue of *RV Magagine,* the trade magazine for the campground industry, an article discussed the trend toward standard use of *campground* as the word campers most frequently associated with a full-service facility. In pointing this out, Brown remarked:

> I think my name might cause people to think of a truck stop. I did used to do a lot of business with truckers before the diesel station closed. But I've got all the basic hookups for RVs that the KOAs or Ponderosas have, yet I don't seem to be getting the business.

Financial situation

24 Brown experienced impressive occupancy rates in the early years (see Exhibit 8) of operation but has seen those figures drop drastically since 1973. Commenting on this, Brown said:

> Business has really been down the last four years. The gas crisis of 1973 and 1974 really hurt us and we haven't recovered yet. We've tried to keep our price very low ($8/single, $10/double) and cut costs by doing most of the work ourselves. I even do the painting on my billboards when I have time. We still have repeat customers, particularly older snowbirds from up north and Canada, but overall occupancy is way down. The trailer park keeps a steady $7,000 to $9,000 business to help out. No doubt we're hurt by not having a restaurant, but I sent some of my guests to a good local restaurant 2½ miles away. My banker thinks we have a poor image and need gimmicks, but I just don't know.

exhibit 8
Annual occupancy rates—motel

Year	*Average room revenue*	*Annual occupancy rate*
1966	$5.50	42.44%
1967	5.60	59.09
1968	5.78	75.29
1969	6.01	66.03
1970	6.40	66.65
1971	6.40	79.22
1972	6.57	90.01
1973	7.15	57.42
1974	8.55	38.38
1975	8.70	39.81
1976	9.15	38.90
1977	9.30	34.41
1978	9.32	35.26

25 After reaching a high of $73,392 in 1972, Congress Motel's room revenue fell steadily to a nine-year low of $39,719 in 1977. (See Exhibit 9.) This decline occurred even though average rates per rented room steadily increased. With the exception of moderate declines in the period 1973–1974, Trailer park revenue has risen steadily since operations began in 1967. (See Exhibit 9.)

26 Commenting on room revenue, Brown said:

> We were doing real good until the '74 gas shortage. Since then, we've never really recovered and things are really getting tight. I've had to get financing for everything I buy and take out several short-term loans to get over critical times (particularly May and September). In 1975, I got SBA [Small Business Administration] to refinance my loans so that I would have longer to pay things off. But now I'm having trouble again.

27 In order to survive the economic conditions of 1973 and 1974, Brown substantially increased his debt (see Exhibit 10), using additional assets as collateral. In 1975, Brown was experiencing severe cash flow difficulties which caused problems in meeting obligations to the SBA. At that time, Brown had two SBA loans and several additional notes payable. The 1975 notes provided for 15 monthly payments totaling approximately $3,964; two additional notes represented a monthly obligation of another $275. These notes accounted for a total liability on August 31, 1975, of $126,720. In 1975, the SBA contracted with a CPA firm to develop a refinancing proposal for Congress Motel. The proposed refinancing program is shown in Exhibit 11. The CPA firm offered the following comments concerning the refinancing proposal:

> Our procedures included meeting with various bank officers, reviewing the possible alternatives with Calvin Brown, and comparing the proposed payment schedule with the current payment schedule.

General refinancing program

> The proposed refinancing program has been developed to help ease the cash flow situation for the current businesses. From our discussions with Brown, it appears reasonable that these businesses may be improved to the point where the cash inflow may improve and these businesses may become profitable again. Even though refinancing may cause additional expense due to penalties or a higher prevailing interest rate, we feel that it is necessary in order to reverse the cash flow.
>
> Our overall approach was to select those notes which required a substantial monthly payment or which extended over 12 months. Four notes which expire by May 1976 have not been considered since they only represent a combined monthly obligation of $355.
>
> The proposed plan will require monthly payments of approximately $2,400; however, this amount drops to $1,653 by June 1976 due to expiring notes. This program may be improved if any of the existing notes may be retired by selling the related collateralized assets. In addition, the note to the Tifton Federal Savings and Loan may be reduced by a release clause if any real estate lots were sold.

28 Brown has two loans through a local bank which are guaranteed by the SBA (90 percent of the loan amount) through its small business loans guaranty program. "My banker has put me in touch with some people at the University of Georgia to try to develop some gimmicks to improve my occupancy," said Brown, "because he [the banker] knows it's hard for me to keep up with my SBA loan payments that are with his bank." Brown continued:

> We've considered changing the name and redoing the signs, but that might cost $210 (minimum) per sign. One guy from SBA talked about that as well as working out something with a local restaurant, getting fishing poles for

exhibit 9

CONGRESS MOTEL
Income Statement
For the Years Ended December 31, 1966 to 1977

	1966	1967	1968	1969	1970
Income:					
Room rent	$10,225.00	$28,958.50	$36,563.00	$49,144.00	$52,940.00
Vending machine	117.27	684.78	887.04	1,019.15	1,063.00
Trailer park	—	2,535.30	3,468.75	5,682.00	6,071.80
Land rent	—	—	—	—	1,200.00
Sign rent	—	—	—	—	—
Miscellaneous income	—	20.20	—	—	171.58
Total income	10,342.27	32,198.78	40,918.79	55,845.15	61,447.18
Expenses:					
Labor	2,390.89	4,756.25	4,004.91	7,059.93	8,079.97
Payroll taxes	107.64	202.10	176.22	299.83	316.46
Linen	2,094.90	3,329.20	—	660.75	257.20
Utilities	1,050.28	4,028.62	4,570.56	4,719.82	5,659.40
Telephone	1,587.06	3,298.16	2,258.81	2,589.90	3,988.56
Supplies	1,217.97	2,360.05	5,231.19	4,106.92	4,774.30
Insurance	250.00	2,323.72	1,157.40	1,229.02	1,794.23
Advertising	831.18	1,903.94	1,325.76	750.81	—
Dues and subscriptions	24.00	—	15.00	—	—
Depreciation	6,004.27	11,268.15	11,022.32	17,174.22	18,236.50
Discounts	6.51	44.96	—	—	—
Interest	6,733.55	7,932.78	9,685.40	7,509.73	11,874.66
Professional service	500.00	240.00	359.50	750.00	—
Rent	—	1,800.00	—	—	—
Repairs	—	701.96	1,013.46	1,012.47	2,819.55
Taxes	—	1,027.78	—	41.15	1,258.44
Royalties	—	815.06	—	—	—
Bad checks	—	—	137.60	—	46.76
Drinks	—	560.22	717.58	—	—
Postage	—	—	21.48	109.36	53.70
Gas and oil	—	—	—	592.42	1,215.11
Sign rent	—	—	—	—	2,261.42
Lease	—	—	—	—	1,600.00
Theft	—	—	—	—	—
Miscellaneous expenses	—	—	516.32	—	177.03
Total expenses	22,799.15	46,592.95	42,183.51	48,606.33	64,413.29
Net income or (loss)	($12,456.88)	($14,394.17)	($ 1,264.72)	$ 7,238.82	($ 2,966.15)

guests to use at my lake and free coffee. But all of that will cost money they will have to loan me and I doubt they will. The SBA man did mention something about a holiday on my SBA (guaranteed) loan payments which would mean $728 per month.

The SBA frequently allows six-month holidays on making payments (with the bank agreeing) when the business can show this would improve its future success in some way.

1971	1972	1973	1974	1975	1976	1977
$62,919.00	$73,392.00	$50,829.00	$40,721.00	$42,966.00	$46,269.00	$39,719.00
1,099.29	1,506.77	556.69	714.03	1,411.55	1,425.92	1,079.54
6,197.00	8,186.75	7,218.25	6,778.75	7,828.65	9,100.09	10,050.25
2,600.00	1,663.61	1,875.00	2,755.00	3,000.00	4,200.00	—
—	—	180.00	195.00	195.00	210.00	210.00
101.10	831.46	1,364.09	1,945.84	307.81	—	(312.58)
72,916.39	85,580.59	62,023.03	53,110.01	55,708.01	61,205.01	50,746.21
8,996.98	9,495.01	7,603.85	7,649.25	7,636.87	8,561.08	7,141.51
428.43	689.11	559.53	474.23	347.31	453.93	377.69
503.60	—	—	—	—	—	—
5,473.98	7,162.84	7,016.87	7,436.03	8,515.53	9,041.32	10,448.30
3,960.43	4,542.37	4,481.58	2,799.13	706.91	778.09	749.03
6,278.57	8,248.67	5,961.13	5,500.97	5,799.46	5,607.13	5,563.92
1,903.47	3,020.27	3,034.23	3,160.70	3,735.82	4,639.79	4,508.67
2,302.26	2,500.01	1,055.88	1,348.16	1,445.48	146.31	548.39
—	379.00	368.00	322.80	—	25.00	15.06
16,807.53	15,027.76	15,594.78	15,047.61	9,990.94	8,263.42	6,949.89
—	—	—	—	—	—	—
8,458.11	8,803.66	7,382.52	10,111.02	11,315.10	10,727.39	8,649.63
600.00	600.00	611.75	396.50	720.00	720.00	1,037.50
—	1,800.00	—	—	—	—	—
2,270.01	3,063.32	4,359.33	2,552.23	2,003.70	2,780.44	2,318.56
3,079.56	82.29	1,907.21	1,510.26	3,356.99	1,780.86	1,838.44
—	—	—	—	—	—	—
—	—	—	—	—	—	—
—	—	—	378.25	—	—	—
80.87	177.70	—	31.00	—	33.00	—
1,066.77	866.76	1,218.90	883.79	848.74	1,393.00	1,210.04
—	—	—	—	—	—	—
—	—	—	—	—	—	—
—	110.00	—	—	—	—	—
—	91.40	106.18	196.19	196.41	—	11.87
62,210.57	66,660.17	61,261.74	59,798.22	56,619.22	55,929.43	51,368.44
$10,705.82	$18,920.42	$ 761.29	($ 6,688.21)	($ 911.21)	$ 5,275.58	($ 622.23)

Operations

29 The Browns handle most of the day-to-day operation of the motel and campground. They hire maids on a part-time basis to clean motel rooms.

30 Brown attempts to do most of the cleanup and basic maintenance himself. Several of the rooms need a new air conditioner, a new TV, and new carpeting. Brown reshuffles these items around so that most (75 percent) of his

exhibit 10

CONGRESS MOTEL
Balance Sheet
For the Years Ended December 31, 1966 to 1977

	1966	*1967*	*1968*	*1969*	*1970*
Assets:					
Cash on hand	$ 300.00	$ 300.00	$ 500.00	$ 100.00	$ 190.09
Franchise	7,500.00	7,500.00	7,500.00	7,500.00	7,500.00
Inventory—antiques	—	—	—	—	—
Land	90,000.00	90,000.00	110,000.00	112,720.71	112,720.71
Fixed assets	136,241.49	138,859.44	144,898.03	167,993.46	172,793.08
Accrued depreciation	(6,004.27)	(18,141.60)	(29,163.92)	(46,690.07)	(64,926.57)
Prepaid interest	1,529.32	842.30	—	—	—
Personal residence	—	—	—	13,893.10	13,893.10
Total assets	$229,566.54	$219,360.14	$233,734.11	$255,517.20	$242.170.41
Liabilities and net worth:					
Bank overdraft	$ 1,586.83	$ 367.72	$ —	$ 913.78	$ —
Payroll taxes	89.46	58.87	104.41	—	134.46
Sales taxes	42.12	14.69	82.30	244.05	153.14
Notes and accounts payable	26,764.20	30,070.87	10,867.55	33,060.89	35,839.96
Mortgage payable	126,981.11	114,137.30	135,916.25	122,363.29	118,051.96
Total liabilities	155,463.72	144,639.53	146,970.51	159,612.01	155,628.68
Net worth:					
Calvin Brown	74,102.82	74,720.61	86,763.60	103,611.45	94,473.04
Drawing	—	—	—	(7,706.20)	(7,931.31)
Total liabilities and capital	$229,566.54	$219,360.14	$233,734.11	$255,517.26	$242,170.41

rooms are in acceptable condition. Several of the rooms need to be painted. Brown plans to do this in the future, "when he can better afford it."

31 The Browns live in a house behind the motel property. They have a buzzer at the motel office, as well as the telephone, connected to their house so that they can ensure response to a customer.

32 Concerning operations and operating expenses, Brown made the following comments:

> I've done a lot to keep costs down. I do almost all my maintenance and yard work. I have cut down on the number of maids I use and, to save even more, I've left rooms uncleaned until all rooms are used up so that maids just come in every other day or so. I took telephones out of the rooms in 1974 because it was costing so much. I've dropped AAA and several other advertising programs. I've also put off repairs on some items such as TVs and air conditioners. Several items like sheets, bedspreads, and shower curtains could be replaced, but I've postponed that. Sometimes I think I would have been better off to have just kept my farm and made this a big trailer park—

1971	1972	1973	1974	1975	1976	1977
$ 1,051.39	$ 1,937.07	$ 169.59	$ 782.83	$ 868.71	$ 2,500.00	$ 76.20
7,500.00	7,500.00	7,500.00	7,500.00	7,500.00	7,500.00	7,500.00
—	—	—	3,500.00	2,500.00	—	—
112,720.71	112,720.71	110,000.00	117,515.00	117,515.00	117,515.00	117,097.50
172,905.47	184,175.57	190,033.71	190,033.71	190,033.71	189,793.60	191,170.07
(81,997.85)	(87,051.63)	(99,761.98)	(114,809.59)	(124,800.53)	(131,497.14)	(138,447.03)
—	—	668.67	6,428.31	7,655.96	6,688.12	5,761.28
13,893.10	13,893.10	13,893.10	13,893.10	—	13,893.10	13,893.10
$220,072.82	$233,174.82	$222,503.09	$224,843.36	$215,165.95	$206,372.68	$197,051.12
$ —	$ —	$ 228.81	$ —	$ —	$ 263.37	$ —
231.89	250.49	215.39	236.14	93.52	207.58	148.79
277.33	135.43	93.32	153.10	176.24	150.33	89.42
35,225.23	51,553.40	63,529.91	90,586.00	59,444.78	53,585.63	32,100.90
—	—	—	—	—	—	—
102,337.37	85,797.17	72,561.03	61,463.39	89,689.01	89,116.71	107,780.29
138,071.82	137,736.49	136,628.46	153,438.63	149,403.55	143,323.62	140,119.40
97,247.55	106,921.42	97,353.91	88,574.63	73,404.73	65,762.40	86,509.33
(9,246.55)	(11,483.04)	(11,479.28)	(16,169.99)	(6,642.33)	(2,713.34)	(9,577.61)
—	—	—	—	—	—	—
$226,072.82	$233,174.82	$222,503.09	$224,843.36	$215,165.95	$206,372.68	$197,051.12

never built the motel—but I did pay off about $100,000 of my SBA loan by 1972 when things were good.

Future directions

33 The Browns are concerned about the future for their business. They see gas prices, chain motels, a dying interchange, and threatening highway beautification billboard laws as major clouds in their future.

34 Brown thinks that advertising gimmicks and a generous buyer are keys to future success. Otherwise, he foresees "hard, penny-pinching times ahead."

35 Sitting in an old reclining chair in the front office with his eyes fixed upon the I-75 traffic, Brown commented:

> I know I've gotta do something. Right now it's like robbing Peter to pay Paul. That sign over there [pointing to a high-rise, red neon sign next to the interchange with the word Motel and an arrow] had the "Congress" blown

exhibit 11
Proposed refinancing program—Congress Motel and Brown's Trailer Park

	Note payable, balance at August 31, 1975	Current plan: Monthly payments	Current plan: Last payment	Proposed plan, monthly payments
SBA 1	$ 47,920[a]	$1,436		$ 574
SBA 2	8,620[b]	336		154
Ashburn Bank	8,320[c]	250		
	7,680[c]	273		225
	1,770[c]	220		
	131	68	October 1975	68
Citizens Bank	12,230[d]	240		
	2,136[d]	107		254
	6,044[d]	178		
	494[e]	123	December 1975	123
Ben Hill	1,270[f]	78		78
Edgar Brown (monthly provisions)	1,200[f]	75		75
C & S Bank—Tifton	560[e]	62	May 1976	62
International Harvester	612[e]	102	February 1976	102
	938[e]	93		93
Safeco Insurance	1,194[g]	398	December 1975	398
Tifton Federal Savings and Loan (monthly provision—interest only)	25,600[h]	200		200
Total	$126,719	$4,239		$2,406

[a] Original, 1966—26-room motel facility, land, pool, office.
[b] On 34-space trailer park/campground and facilities.
[c] On two portable trailer units with four single (motel) rooms in each.
[d] On five acres of land—for operating capital.
[e] On equipment.
[f] Loan from friend—operating capital.
[g] Financed insurance premium.
[h] Loan on 43 house lots—operating capital.

off by a tornado in 1975. Maybe I should change my name, but then I'd have to replace the Motel part and that'd cost. I sometimes wish I could just sell this place. A lot of foreigners, especially Arabs, are buying up businesses and farms around here since it's close to Plains. One talked to me through a realtor; he was from Venezuela, but he would only put 20 percent down. Well, I've gotta do something. Maybe, since I'm close to Jimmy Carter territory, I should call it Carter Inn.

chapter 1 alternate cohesion case

Strategic management and Congress Motel

Chapter 1 has provided you with a broad introduction to strategic management. What roles does strategic management play (or could it play) at Congress Motel? Based on the material in Chapter 1, this question can be answered by addressing four issues.

1. Is Congress Motel facing a strategic decision?
2. Does Congress Motel have a strategy?
3. What value would strategic management offer Congress Motel?
4. What strategic management structure is appropriate at Congress Motel?

Is Congress Motel facing a strategic decision? Yes! It has experienced steadily declining profitability since 1974, due in large part to changing conditions in its external environment. These changes threaten the future existence of Congress Motel. A future-oriented decision is required by top management (Calvin Brown), involving a major allocation of company resources, which is likely to have significant impact on the long-term viability of the firm.

Does Congress Motel have a strategy? Yes and no! There is no formal strategy at Congress Motel. Brown appears to be operating via crisis management or management by exception, attacking pressing problems on a daily basis without any long-term continuity in his decision making. However, implicit in its approach to the market, an informal strategy of protecting a niche (often called retrenchment) within the strategy of targeting the low-priced travel accommodation segment of the (Georgia) I-75 travel industry seems apparent at Congress Motel.

Could Congress Motel benefit from strategic management practices? Yes! A well-defined strategy should help Congress Motel stem the profitability decline, even if that strategy is divestiture. Furthermore, numerous behavioral benefits may accrue to Brown in terms of easing the crisis management cycle that currently inhibits his managerial effectiveness.

If Congress Motel undertakes a strategic management, what strategic management structure should it adopt? As shown in Figure 1–2 (Chapter 1), Congress Motel would appear to best fit alternative 1—the single-business firm. Brown needs to develop an overall business strategy and functional strategies to implement the business strategy. There is room for argument that Brown could use alternative 2. Here, one might argue, Brown needs an overall corporate-level strategy defining the firm's posture in the travel accommodation industry; two business-level strategies guiding the actions of

his motel and campground businesses; and two sets of functional strategies implementing each business strategy. However, given the size of Brown's operations, addition of the corporate level appears unnecessary.

chapter 2 alternate cohesion case

Strategic management process: The case of Congress Motel

If strategic management could benefit Congress Motel, how should Brown organize his strategic management efforts? Could the strategic management process outlined in Chapter 2 be useful?

The answer appears to be yes, with certain modifications recognizing the size of the firm and the current demands on Brown. First, the approach adopted by Brown should be systematic but not highly formalized. Given the small size of the firm and the critical role of Brown in operational activities, a highly formalized process would be inefficient and ineffective.

Second, recognizing Brown's lack of previous planning activity, he would be well advised to incorporate an outside person in this undertaking. Assuming the role of a consultant-planner, this person could help ensure Brown's serious commitment to systematic strategic analysis, supplement his lack of planning experience, and likely speed up the process. Fortunately for Brown, a free, small-business consulting service was available to small Georgia firms through the University of Georgia's College of Business Administration. He could also use such outsiders as bankers, CPAs, private consultants, or fellow business managers if the planning skill and serious commitment was available.

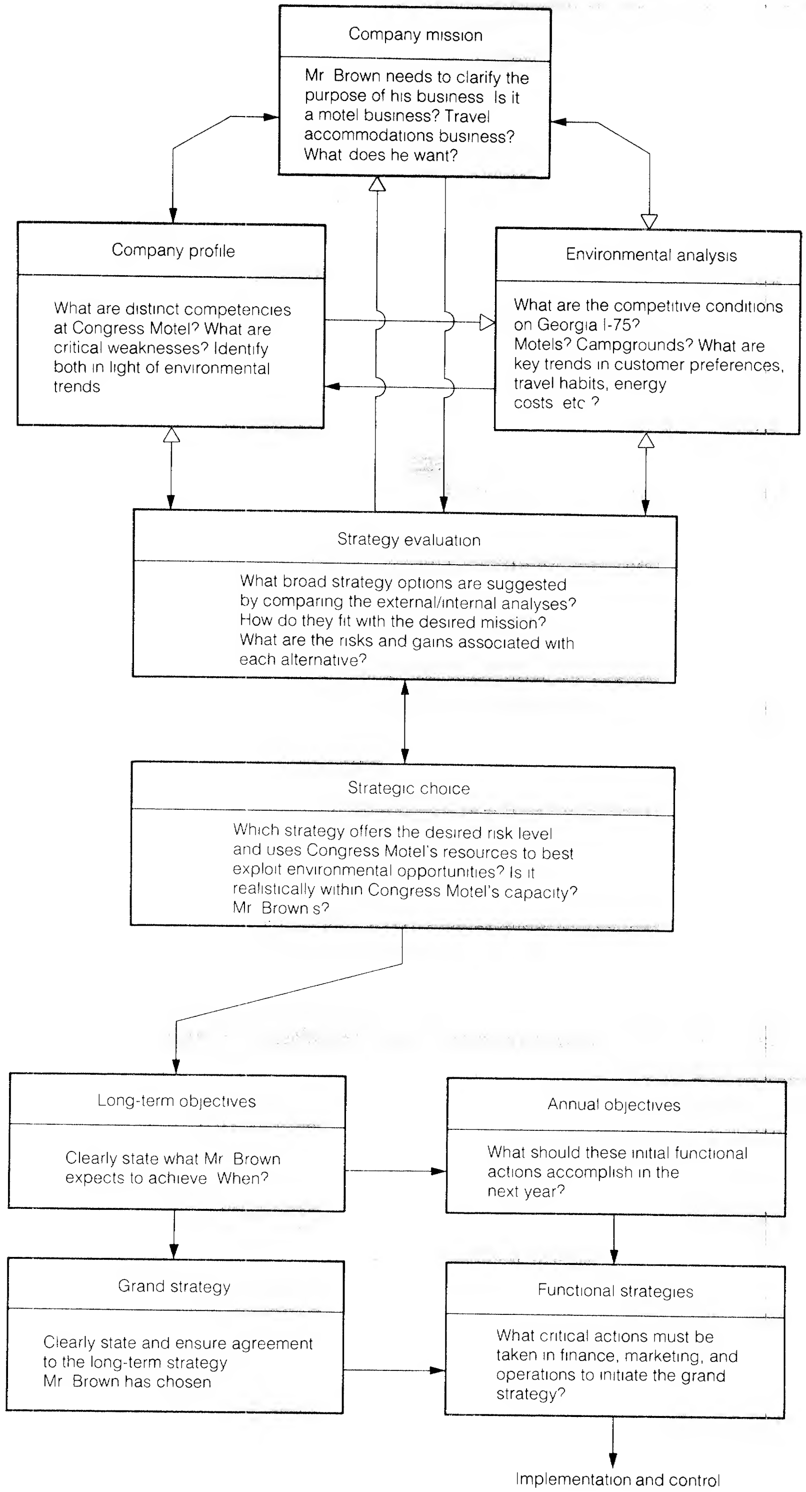
Brown, working with a consultant-planner, could adopt a systematic strategic management process similar to that offered in Chapter 2. Exhibit 1 illustrates how the strategic management process might be organized at Congress Motel.

Brown should be involved at all phases, but the consultant-planner would have to assume a major role as a facilitator and data gatherer if the process is to succeed. The facilitator role would be important to ensure Brown's regular attention to the strategic management process in competition with the demands (on Brown) from day-to-day operating problems. The data-gathering role is essential because Brown would not have the time to systematically and rapidly gather sufficient external data to support the strategic management process.

The remaining Cohesion Cases apply each component of the strategic management process to Congress Motel.

exhibit 1

Strategic management process at Congress Motel



chapter 3 alternate cohesion case

Defining the company mission: Brown and Congress Motel

Calvin Brown finished Ashburn High School in 1947. He received the American farmer's degree from a Kansas City vocational program two years later. For the next 17 years, Brown had a family farming operation near Ashburn, Georgia.

In 1966, with Interstate 75 being built adjacent to some of his farmland, Brown chose to enter the motel business as an alternative to a lifetime of sporadic profitability as a family farmer. Since I-75 promised to be a major tourist route to Florida, Brown sought to capitalize on the location of his farmland and reap the promise of steady profits with his own interstate motel. **(6)**[1]

Eleven years later (1977), Brown's dream of steady profits had become a recurring nightmare since 1973. Brown's perception of the mission of his business had changed very little over these 11 years. In fact, mission, objectives, and purpose were never seriously considered at Congress Motel through 1977. Exhibit 1 summarizes Brown's perception of the firm's mission in early 1977, before engaging in a strategic management process.

exhibit 1
Definition of company mission at Congress Motel: 1966–1977

1.	Why firm was founded?	To avoid sporadic profits in family farming and get into a promising, stable business. **(1, 5)**
2.	What was the original mission of the firm?	To rent to vacationers and make a steady, reasonable profit. **(1)**
3.	Has it changed over the years?	No. Still want to rent rooms and make a profit—but profit hasn't been there since 1973. **(25–27)**
4.	How does the campground fit in?	Brown built the trailer park in 1967 because his family took vacations in this manner. The campground helps out with extra income. **(16)**
5.	What should be the nature of the business now? In the future?	To rent more rooms so profits will improve. **(21)**
6.	What services should be provided in the future?	Clean motel rooms, maybe some gimmicks like free peanuts, and also camping. **(28)**
7.	What are the key goals of Congress Motel?	To survive and make a profit. **(25)**

[1] Numbers which are typed in parentheses at the end of sentences refer to paragraph numbers in the business case study.

The definition of company mission that emerges from Exhibit 1 is quite vague. Apparently, Brown has not given much time or effort to the clarification of company mission since founding the firm. This lack of direction might well be a contributor to the declining situation at Congress Motel and trailer park.

In June 1977, Brown adopted the strategic management process as a repetitive decision-making activity at Congress Motel.[2] Considerable attention was given to the clarification of the company mission. Exhibit 2 presents the clarification achieved on the questions asked in Exhibit 1.

Brown has now developed a clearer concept of the firm's present and future mission. The clarification he has achieved as evidenced in Exhibit 2 provides a stronger basis for effective planning at Congress Motel.

exhibit 2

Clarification of company mission at Congress Motel

1. What is the mission of Congress Motel and trailer park?	To provide low-cost, appealing accommodations to the budget-conscious vacation and business traveler on I-75 between Macon and the Florida line. **(7, 21)**
2. How has it changed? How will it change for the future?	This business is small yet diversified in that it offers motel rooms and campsites for RVs and tent campers. Major emphasis has been with the motel. Equal emphasis will be placed on the campground for now, with increasing emphasis in the future. **(35)**
3. What should be the nature of the business now? In the future?	To provide adequate, appealing, low-priced rooms and campsites for now; in the future, to provide reasonably priced, full-service RV and tent campsites with full amenities (miniature golf, pool, lake, fishing) available and low-priced, clean motel accommodations as well.
4. What are the key goals of the motel and trailer park?	For the motel the immediate goal is to increase occupancy to a steady, breakeven point of 42 percent; the long-term goal is to maintain an average annual occupancy of 50 percent. For the campground the long-term goal is to increase occupancy by an absolute 10 percent per year for the next five years, with campground revenues exceeding motel revenues by 2 to 1 in five years. **(24, 27)**

[2] With the assistance of planning consultants from the Small Business Development Center (SBDC) in Athens, Georgia.

Questions

1. How did Brown's past and his values lead to his vague definition of company mission for the first 11 years?
2. Did the definition of company mission from 1966 to 1977 influence the declining performance that started in 1973? Why?
3. Do you agree with Brown's clarification of company mission in Exhibit 2? Why or why not? What aspects are particuarly strong and what deficiencies would you improve?

chapters 4 and 5 alternate cohesion case: Assessment of the firm's environment: The case of Congress Motel

The decision making at Congress Motel was sporadic and inconsistent. Brown's crisis management approach resulted in repeated fire fighting against the symptoms of internal problems, consistently at the expense of a systematic assessment of the firm's environment. During discussions with SBDC consultants, he agreed to go through a systematic analysis of Congress Motel's environment via the strategic management process.

Assessment of Congress Motel's environment

With the help of Small Business Development Center consultants, Brown analyzed his firm's environment in a manner similar to the environmental assessment process described in Chapter 4 and 5. Exhibit 1 presents the results of Brown's analysis of Congress Motel's remote external environment. Clearly, the overall remote environment is rather unfavorable with the exception of the baby-boom generation reaching the family age and travel age.

Exhibit 2 provides the summary analysis of the task environment. Two important factors stand out as potential opportunities: campground-related demand and competition, and availability of SBA loan holiday periods.

These analyses suggest several opportunities and threats in Congress Motel's environment which its chosen strategy must address. The next *Cohesion Case* will examine Congress Motel's internal strengths and weak-

exhibit 1
Assessment of Congress Motel's remote environment

Remote environment factors	*Evaluation*	*Forecasting technique*
1. Economic. Energy crisis; impact on gasoline prices becoming a major factor on vacation travelers. **(24)**	Very unfavorable	Judgmental scenario
2. Political. President Carter's election influence on visitors to southwestern Georgia is positive but Lady Bird Johnson's Highway Beautification Act threatens life-giving billboards. **(35, 33)**	Unfavorable	Judgmental
3. Social. World War II baby boom now starting families might increase number of budget-conscious vacation travelers. **(2)**	Favorable	Trend analysis
4. Technological. Reservation systems becoming commonplace in motels. **(2)**	Unfavorable	Judgmental

nesses. Once this is done, you can compare the internal analysis with the environmental assessment just completed to generate the most appropriate strategy alternatives.

exhibit 2
Assessment of Congress Motel's task environment

Task environment factors	*Evaluation*	*Forecasting technique*
1. Competitors (motel). Large number of chain motels (8,280 rooms by 1980) between Atlanta and Florida. **(2, 10)**	Unfavorable	Trend analysis
2. Competitors (campground). Scarcity of RV and tent camping facilities (840 total spaces) between Atlanta and Florida. **(9, 10)**	Very favorable	Trend analysis
3. Customers. Increasing volume of vacation (cars and RVs) traffic on south I-75. Gradually decreasing demand for motel accommodations while rapidly increasing demand for camping accommodations. **(8, 9, 10)**	Favorable	Surveys and trend analysis
Strong association of quality, newer facilities, and amenities in customers' minds with word *inn* versus *motel* and, for RV customers, with the word *campground* versus *trailer park*. **(22, 23)**	Unfavorable	Surveys
4. Labor market. Rural area with supply of part-time maids. **(11)**	Favorable	Judgmental
5. Creditors. Bankers hesitant to loan additional funds but SBA loans (two) are eligible for six-month holidays. **(28)**	Favorable	Survey
6. Suppliers. Long-term agreements from 1967 with local property owners for billboard locations at only 10 percent of current average billboard cost on I-75. **(19)**	Very favorable	Observation

chapter 6 alternate cohesion case
Internal analysis at Congress Motel

Congress Motel and Brown's Overnite Trailer Park was an independent motel/campground business opened in 1967 adjacent to Interstate 75 in southwest Georgia by Calvin Brown and his wife. Brown has been a farmer prior to opening his motel/campground. The motel had 34 rooms, 26 were part of the original concrete block structure and 8 were portable rooms. The campground has 34 sites, 26 full-water/electricity/sewage hookups.

The SBDC was contacted by Brown's banker.[1] The banker was concerned about Brown's difficulty in staying current with two SBA guaranteed loans as well as the overall state of the business. The motel occupancy rate had dropped from a high in 1971 of 91 percent to an average of 37 percent for 1974 through 1977.

Initial assessment: Crisis management

SBDC consultants first met with Brown at his business in September 1977. Below are excerpts from the consultants' report on this initial visit:

> Congress Motel facing severe cash flow problems . . . mainly a decline in sales and low motel occupancy . . . Brown attributes problems to gas crisis of 1974 and growth in I-75 motel chains . . . very focused on monthly expenses . . . trying to do things like cut grass, paint billboards, and repair air conditioners to save money . . . little emphasis (by Brown) on dynamics of the south I-75 travel industry other than his immediate interchange . . . minimal attention to the campground's potential no occupancy records kept . . . (Brown) hopes we (SBDC) can get him gimmicks to increase motel occupancy.[2]

Internal analysis of the firm

With the help of SBDC consultants, Brown was encouraged to analyze his firm in a structured manner similar to the internal analysis process described in Chapter 6. Exhibit 1 presents the results of this analysis. Brown (with SBDC assistance) identified key strengths and weaknesses of his business.

The analysis, when matched with the previous environmental assessment, led to the development of a simple planning matrix shown in Exhibit 2.

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[1] The Small Business Development Center (SBDC) is a statewide program providing management assistance to small businesses. Besides Georgia, these programs exist in 20 other states in the United States.

[2] University of Georgia SBDC, case file 081, "Congress Motel."

exhibit 1
Internal analysis at Congress Motel

Strategic internal factors	*Hi Weaknesses*			*Neutral*	*Hi Strengths*		
1. Business names/image. *Motel* conveys mom-and-pop image; *Overnite Trailer Park* conveys same; *Congress* not helpful in terms of anti-Washington atmosphere.	−3	−2	−1	0	+1	+2	+3
2. Prices. Second lowest motel price ($8 single) and lowest campground price within 150-mile radius.	−3	−2	−1	0	+1	+2	+3
3. Cash position. Very poor/minimal working capital.	−3	−2	−1	0	+1	+2	+3
4. Billboards. Cost a major advantage—owns all boards; number of signs (12), a major advantage; sign copy—a disadvantage, done by Brown to save money and price advertised on 4 of 12.	−3	−2	−2	0	+1	+2	+3
5. Location. Semidying interchange, one gas station, two miles to a restaurant, but quiet and serene.	−3	−2	−1	0	+1	+2	+3
6. No restaurant. Too costly.	−3	−2	−1	0	+1	+2	+3
7. Condition of property. Motel relatively new, 1966; campground reasonably scenic—but laundry and showers need clean-up.	−3	−2	−1	0	+1	+2	+3
8. Extras. Swimming pool, miniature golf, three-acre lake, picnic tables.	−3	−2	−1	0	+1	+2	+3
9. Campground. 26 out of 34 spaces with water, electrical, sewage hookups; other 8 with water for tent campers; all paid for in 1967.	−3	−2	−1	0	+1	+2	+3
10. Breakeven point. Motel, 52 percent occupancy, campground, 18 percent occupancy.	−3	−2	−1	0	+1	+2	+3

This planning matrix attempted to focus Brown's attention on developing strategies that (1) maximized utilization of his strengths, (2) avoided basing strategies on critical weaknesses, (3) targeted potential opportunities on which to focus his strengths, and (4) minimized the impact of major threats.

The planning matrix sets the stage for Brown to match the results of his internal analysis with the results of his environmental assessment to generate viable strategies and actions. With the inclusion of the environmental factors, the planning matrix now has the two key dimensions completed. The generation of strategic alternatives can now be guided by a systematic consideration of the interaction between internal competencies of the firm and the external characteristics of the environment. This increases the likelihood

exhibit 2
Congress Motel's planning matrix: environmental analysis

Internal analysis	ENVIRONMENTAL OPPORTUNITIES				
	Increased I-75 traffic volume	*Increased demand for camping*	*Lack of camping facilities available*	*Cost of competitors getting into camping business*	*Increased days in Georgia*
STRENGTHS: Prices and low breakeven point					
Number (12) and costs of billboards					
RV campground facility paid for					
Extras (pool, miniature golf, lake, picnic)					
WEAKNESSES: Name and image—motel and trailer park					
Billboard copy: (hand painted, wording, price and campground)					
Cash position Lack of working capital					
No restaurant					
Lost AAA rating					

of choosing more successful strategies since they are not based upon isolated consideration of either internal or environmental dimensions. The use of the planning matrix for generating alternative strategies will be covered in the next two Cohesion Cases.

		ENVIRONMENTAL THREATS			
Cost of signs on I-75 south	*Possible SBA six-month loan repayment holiday*	*Over competitive motel industry on I-75 south*	*Name recognition and image associated with motel*	*Name recognition and image associated with trailer park*	*SBA/bank receptivity to additional loans or refinancing*

chapter 7 alternate cohesion case

Grand strategy alternatives at Congress Motel

The annual occupancy rate at Congress Motel had dropped from a high in 1971 (91 percent) to an average annual rate of 37 percent between 1974 through 1977. With a breakeven point of approximately 52 percent, Congress Motel probably experienced four lean years. As you can see from the income statements in the text of the case study, this indeed was the situation.

In seeking to identify alternative grand strategies for Congress Motel, we must match its company profile (internal analysis) and environmental assessment consistent with the clarified company mission. This should identify the ultimate purpose of grand strategy. The next three exhibits recapitulate the results of the mission definition, company profile, and environmental assessment/forecast at Congress Motel.

Clarification of the company mission at Congress Motel (Exhibit 1) finds Brown defining his firm as providing budget travel accommodations. His key long-term objectives suggest pursuit of survival and stability, with an increasing emphasis on the campground side of his operation.

exhibit 1
Clarification of company mission: Congress Motel

1. What is the mission of Congress Motel and trailer park?	To provide low-cost, appealing accommodations to the budget-conscious vacation and business traveler on I-75 between Macon and the Florida line. **(20)**
2. What are the key goals of the motel and trailer park?	For the motel, the immediate goal is to increase occupancy to a steady, breakeven point of 52 percent; the long-term goal is to maintain an average annual occupancy of 60 percent. For the campground, the long-term goal is to increase occupancy by an absolute 10 percent per year for the next five years with campground revenues exceeding motel revenues by 2 to 1 in five years. **(24)**

The company profile identified a few basic strengths and several major weaknesses at Congress Motel, as summarized in Exhibit 2.

Several key environmental factors were identified, which are summarized in Exhibit 3. The environment presented several unfavorable factors, especially competitive factors, consumer name preference, and interchange conditions. Environmental forecasting, however, uncovered limited but important and favorable trends regarding the campground business as well as SBA financing options.

exhibit 2
Company profile: Congress Motel

1. Business names/image. *Motel* conveys mom-and-pop image; *Overnite Trailer Park* conveys same; *Congress* not helpful in terms of anti-Washington atmosphere. **(17, 22, 23)** (weakness)
2. Prices: Second lowest motel price ($8, single) and lowest campground price within 150-mile radius. **(21, 24)** (strength)
3. Cash position. Very poor; minimal working capital. **(25)** (weakness)
4. Billboards. Cost, a major advantage—owns all boards; number of signs (12), a major advantage; sign copy, a disadvantage, done by Brown to save money and price advertised on 4 of 12. **(33)** (strength and weakness)
5. Location. Semidying interchange, one gas station, two miles to a restaurant, but quiet and serene. **(12)** (weakness)
6. No restaurant. Too costly. **(16)** (weakness)
7. Condition of property. Motel relatively new, 1966; campground reasonably scenic—but laundry and showers need cleanup. **(13)** (strength)
8. Extras. Swimming pool, miniature golf, three-acre lake, picnic tables. **(14)** (strength)
9. Campground. 26 out of 34 spaces with water, electrical, sewage hookups; other 8 with water for tent campers; all paid for in 1967. **(13)** (strength)
10. Breakeven point. Motel, 52 percent occupancy; campground, 18 percent occupancy. **(24)** (strength)

exhibit 3
Environment assessment/forecast: Congress Motel

1. South I-75 travel industry characteristics (Atlanta to Florida):*

	1976	*1980*	*1990*
Average daily volume:			
Cars	26,000	36,000	44,600
Recreation/vacation	8,840	12,240	14,960
Number of motel rooms available		8,280	9,108
Number of cars desiring motels		6,187	7,779
Average occupancy rate—south I-75 motels		78%	85%
Number of campsites (RV) available		840	1,680
Number of vehicles desiring camping		1,469	2,244
Average potential occupancy rate—south I-75 campgrounds		175%	133%

	1967	*1975*	*1977*
Average number of days in Georgia			
1–2 days	68%	51%	50%
3 or more	32	49	50
Type accommodations desired:			
Motel	66	53	50
Campground	1.8	10.5	12.8

2. Name recognition according to trade magazines: *Inn* is more recognized as clean, safe, and desirable than *motel*; *campground* more recognized as RV area than any other.
3. SBA or bank loan availability; not much receptivity.
4. SBA loan repayment holidays. With good reason, SBA guaranteed loan payment can be postponed for six months and renewed for subsequent six months.

* Available through state of Georgia Welcome Center surveys.

exhibit 4

Congress Motel: Matching company profile and environmental assessment

	OPPORTUNITIES				
	Increased I-75 traffic volume	*Increased demand for camping*	*Lack of camping facilities available*	*Cost of competitors getting into camping business*	*Increased days in Georgia*
STRENGTHS: Prices and low breakeven point	Increase in number of budget-conscious travelers	*Key advantage:* Current prices of $3.25 per day for campsite can be raised by $1 and still be below south I-75 average			
Number (12) and costs of billboards	Repeat exposure	*Key advantage:* Ability to get good advertising exposure about campground for interstate traveler at minimal long term cost to Brown			
RV campground facility paid for		*CRITICAL:* Obvious strategic advantage matching unused strength with sizable market opportunity			
Extras: (pool, miniature golf, lake, picnic)	Important to more travelers	*Advantage:* Attractive to camper families			
WEAKNESSES: Name and image—motel and trailer park	Need to improve for repeat business				
Billboard copy: (hand painted wording, price and campground)					Emphasize recreational extras
Cash position Lack of working capital					
No restaurant	More travelers not concerned, possibly	Often self-contained; don't need restaurant			Hurts likelihood of stayovers; must deal with somehow
Lost AAA listing	Same as above				

		THREATS:			
Cost of signs on I-75 south	*Possible SBA six-month loan repayment holiday*	*Over competitive motel industry on I-75 south*	*Name recognition and image associated with motel*	*Name recognition and image associated with trailer park*	*SBA bank receptivity to additional loans or refinancing*
		Brown's break-even point offers strategic advantage			
Key advantages: Exploit use of all these (12) signs					
		CRITICAL: Place emphasis on campground facility and on motel price			
		Important: Chain-type extras at no extra cost—emphasis on signs			
	CRITICAL: Source of working capital to change signs, image, and make improvements	*Important:* Target market family, budget-conscious, outdoor-oriented travelers	*CRITICAL:* Change names to reflect current consumer preference for *Inn* and *Campground*. *Lakeview* projects image attractive to recreational vacationing traveler		
	CRITICAL: Source of cash flow to change signs		*CRITICAL:* Signs must be professional, simple, standardized with equal billing for campground to improve *image*		
	CRITICAL: Allows $748/month additional cash flow to pay for changes				*Important:* Avoid wasting time along this route
		Distinct disadvantage: especially at motel. Try to make local discount arrangement			
					Sell portable rooms—get back AAA and reduced debt

To set up the determination of alternative grand strategies, the strategist must first match and diagnose the company profile and environmental assessment. This has been done in Exhibit 4. Comparing strengths and weaknesses of the firm with favorable and unfavorable factors in the environment, the strategist searches for and identifies critical points of interaction. For example, the increasing demand for camping facilities (environmental factor) and Brown's underutilized campground with RV hookups (internal factor) provide a critical, interactive opportunity which future strategy must consider. On the other hand, the negative image associated with the word *motel* by the traveling public (unfavorable environmental factor) and the name Congress Motel (internal factor) present a critical, interactive threat which the future strategy must also consider. Matching (and diagnosing) the remaining internal and external factors, you can see that the purpose of Congress Motel's grand strategy will primarily be to overcome weaknesses and threats rather than maximizing strengths and opportunities.

Applying this information to the grand strategy selection matrix which was Figure 7–7 in Chapter 7, we can begin to narrow the viable grand strategies for Congress Motel. To complete this narrowing, we must decide whether Congress Motel will have to emphasize internal capabilities or acquire external capabilities to pursue its eventual strategy (see Figure 7–7 in Chapter 7). Clearly, Congress Motel will have to depend on internal capabilities and resources, for it is not realistic that external acquisition of resources or capabilities is within Congress Motel's ability.

For Congress Motel, the realistic grand strategy options are characterized by those that seek to overcome weaknesses (and threats) while depending upon a redirected use of existing internal resources as depicted in Exhibit 5. Four grand strategies emerge as possible options.

1. Turnaround.
2. Divestiture.
3. Retrenchment.
4. Liquidation.

In the next Cohesion Case, we will illustrate the dynamics of evaluating and choosing one of these grand strategies.

exhibit 5
Grand strategy selection matrix: Congress Motel

	Areas of emphasis	
Purpose of the grand strategy	*Internal (redirect resources within the firm)*	*External (acquire resource capability)*
Overcome weaknesses	Quadrant II Turnaround Divestiture Retrenchment Liquidation	
Maximize strengths		

chapter 8 alternate cohesion case

Strategy evaluation and choice at Congress Motel

In the last Cohesion Case, we narrowed the realistic alternative strategies for Congress Motel to (1) turnaround, (2) retrenchment, (3) divestiture, and (4) liquidation. What do these strategies mean when applied specifically to Congress Motel? How can we evaluate them? Which would be the best choice? These are questions we addressed in Chapter 8. You need to answer them relative to the specific situation at Congress Motel.

What do these broad grand strategies really mean when applied specifically to Congress Motel? Exhibit 1 helps provide an answer. While they may emanate from the same broad situational factors, they represent rather distinct options when applied to the situation facing Congress Motel. And to make a logical choice, we must comparatively evaluate the four options.

exhibit 1

Defining grand strategy options for Congress Motel

Grand strategy	*How it would be applied at Congress Motel*
Turnaround	A turnaround should seek to minimize aspects of Congress Motel's operations that are unprofitable and redirect resources and efforts into areas that have greater potential. At Congress Motel, this could be a serious belt tightening in its votel operation and a gradually increased improvement of its campground facilities.
Retrenchment	A retrenchment strategy would be similar to the turnaround strategy with the exception that the belt tightening would occur in both motel and campground operations. Here, Brown would seek to cut costs, curtail services, limit variable expenditures to a survival level to ride out major environmental threats, and gradually rebuild financial strength.
Divestiture	A divestiture strategy would have Brown seeking to sell the total business to another operation, competitor, or alternate user as a going concern.
Liquidation	Liquidation would have Brown selling off all property, equipment, etc.—possibly even bankruptcy—to pay off his debts and start anew in another location or another occupation.

How should these four options be evaluated? One logical way is to comparatively examine how each option would make use of Congress Motel's internal resources in light of the environment conditions it can expect to encounter. This has been done in Exhibit 2.

exhibit 2
Strategy evaluation at Congress Motel

Strategy	*Evaluation*
Turnaround	While facing numerous threats and internal weaknesses relative to its motel operation, the dramatic and steady rise in the demand for I-75 camping facilities matches CM's campground capacity. This would require a name change and would cost $210/sign in terms of repainting billboards. Motel side has bleak future, so cannot build turnaround on it. But the motel does provide some cash flow if loan holiday is obtained to chart long-term rebuilding around campground-oriented facility.
Retrenchment	Brown has essentially been doing this since 1974 and it hasn't worked. He has cut back services, expenditures, maintenance, and sold off some assets relative to both the motel and campground. Environmental threats are long term, so continuing retrenchment represents imminent death.
Divestiture	Psychologically, it might be good for Brown to get out from under operating this business. But realistically, few buyers would want the business given its interchange characteristics and performance history. Speculators, like foreign investors, appear only willing to put down 25 percent—not enough to get Brown out of current obligations—leaving him with the prospect of having to reassume a totally rundown property.
Liquidation	This might be psychologically appealing, but likely price would be inadequate as demonstrated above. Brown would likely have to take bankruptcy if he chooses this option and start over at 55 years old.

Comparing the evaluation of the four strategies, Brown's choice is rapidly narrowed. Retrenchment appears unacceptable (by itself), primarily because that has been the inherent strategy since 1974 and it seems clearly a slow death. Divestiture or liquidation promise psychological relief for Brown in unloading the property, but pursuing either of these as a key strategy would be unrealistic. The likelihood of finding a credit-worthy buyer with the necessary upfront money is remote. A turnaround strategy is almost the choice by default. It does, however, represent a risky but viable alternative, given the strong trends in demand for camping, Brown's existing campground facilities, and the relatively low capital investment he would be required to make.

chapter 9 alternate cohesion case

Functional strategy implementation at Congress Motel

The grand strategy for Congress Motel, a turnaround strategy, seeks to maximize its limited strengths and opportunity in the campground area as a means for overcoming the numerous weaknesses associated with its overall business posture. While this is quite logical, Congress Motel provides you with a lucid example of why functional strategies are so important—as both a last-chance test of the grand strategy's consistency and as the beginning of implementation. Congress Motel's current situation is precarious. So developing functional strategies to operationalize the grand strategy lets us test the consistency of the strategy with the functional capabilities at Congress Motel. And since the situation is so precarious, developing functional strategies to initiate action (implementation) is of the utmost urgency.

What should the functional strategies be? We suggest the following series of functional strategies broken down in order of priority (relative to turning around the desperate situation at Congress Motel):

1. (financial strategy) Cash flow—negotiate six-month SBA loan holiday with additional six-month option—necessary to generate cash flow to implement other actions; represents two SBA loans with $748 total monthly payment. This financial strategy is imperative to relieve cash flow pressures in order to give Brown the time and internal financial resources to implement the other functional strategies critical to the success of a turnaround strategy.

2. (marketing strategy) Change name to Lakeview Inn and Campground. A name change for both the motel and campground is essential if Brown is to attract more attention from the typical interstate traveler. We suggest Lakeview Inn and Campground because it uses current terminology, gives increased emphasis to the campground; and since the property borders a lake, it provides an image consistent with the atmosphere most campers seem to desire.

3. (marketing strategy) *Professional* repainting of all billboards using standardized copy and color scheme; emphasis on price, campground facilities, and extras with equal billing to campground. This marketing strategy is critical to the success of a turnaround strategy. Billboards are the major means for an interstate motel (particularly an independent) to communicate with its potential customers. Brown's signs need to be professionally done to project a better image and need to have standardized copy giving equal billing to the campground. With 12 signs, this can be the only advance (other than price) Brown has.

4. (marketing strategy) Raise prices of campground facilities by $1 to coincide with name change. This can be done and still maintain the lowest price advantage. It also improves cash flow and hastens the time when the campground will become a major revenue source.

5. (operating strategy) Improvement of condition of motel/campground property—campground laundry and showers having first priority. This should be done gradually, so cash flow will not be jeopardized. Emphasis of the campground side to attract repeat customers and because, with low motel occupancy, Brown can salvage parts of some rooms to keep 60–70 percent of rooms in good condition.

6. (operating and financial strategy) Consider alternative use of portable rooms which caused AAA rating loss. Selling the portable rooms could eliminate one of Brown's debts—thereby permanently improving cash flow.

7. (operating strategy) Investigate arrangement with local country restaurant for discount arrangement for motel/campground guests. This could lessen the severity of the weakness attributable to the absence of an on-property restaurant. Since Brown cannot afford to build or operate one, this is the only viable alternative.

These are the key functional strategies that the turnaround would depend on. They seem reasonably within Congress Motel's capabilities, providing a positive test of consistency. And as shown by the purposeful priorities, they can quickly implement the new strategy.

chapter 10 alternate cohesion case

Strategy implementation and control at Congress Motel

What other implementation tools must Brown use to implement the turnaround strategy in addition to the functional strategies outlined in the last Cohesion Case Section?

The primitive organizational structure would be an important tool for strategy implementation. This is clearly what Brown now has, so no real change is necessary. While indeed taxing on Brown, this structure would ensure that he makes all key decisions thereby keeping control over the tight financial situation. He should be sure to delegate some activities—like sign painting and bookkeeping—while maintaining tight control over operational activities.

The situation is desperate, so Brown's leadership style should communi-

cate the need for tight control to the few employees he utilizes. He must ensure an atmosphere of strict accountability and maximum productivity to make maximum use of his human resources in this turnaround effort.

Budgeting and scheduling are key implementation tools Brown must use. He does not need elaborate and sophisticated schedules or budgets, but rather a simple *cash flow/expenditure budget* with a related *schedule* covering key operational actions.

The cash flow/expenditure budget should project necessary expenditures (operating as well as sign painting, property improvements, etc.) based on historically derived revenue patterns and the elimination of the SBA payments for six months and one year. This is a critical tool to ensure Brown doesn't overextend himself in implementing the turnaround strategy. Otherwise, he might get half of his signs repainted, for example, and have to postpone the remainder for some indefinite period.

The schedule, recognizing the functional priorities presented in the last section, should carefully time the key actions necessary to implement the turnaround strategy. Obviously, this schedule must be consistent with the cash flow/expenditure budget to avoid occurrences like the sign painting example above. Furthermore, the schedule will force Brown to logically plan and implement critical timing-related aspects like the name change to ensure coordination with billboards, in-house items, price lists, and so forth.

As we noted in the last case, while the turnaround strategy is the most logical it is still inherently risky. Internal or external factors might change. Unforeseen problems may arise. So Brown must have a simple but usable review and evaluation mechanism to monitor the impact of the new strategy to determine if it is working or if it needs adjusting or radical change. Perhaps the best, simple system would be a daily occupancy/revenue comparison for both the inn and the campground compared to the same day last year. This is common to most motel operations. Brown would be able to see, as time progressed, if a true turnaround trend was developing. If it was, he could confidently carry out lesser priority actions in the turnaround strategy. If not, he would have advanced warning to adjust or change his strategy.

part four

Business case studies in strategic management

section A
Company mission

case 1
Wendy's International, Incorporated

1 In just 11 years, Wendy's International has grown from one store to over 1,800 company-owned and franchised outlets. Between 1974 and 1979, Wendy's growth has been explosive with sales, including company-owned and franchised units, growing 4,200 percent ($24 million to $1 billion). In the same period, revenues from company-owned store sales and from franchise royalties grew 726 percent ($38 million to $274 million). Net income has increased 2,091 percent in this period from $1.1 million to $23 million. Earnings per share have likewise made substantial gains from $.12 in 1974 to $1.54 in 1979, a 1,283 percent rise. Wendy's has grown to a position of being the third-largest fast-food hamburger restaurant chain in the United States, ranking behind Burger King and McDonald's, the leading U.S. hamburger chain.

2 Wendy's entry and amazing growth in the hamburger segment of the fast-food industry shocked the industry and forced competitors within it to realize that their market positions are potentially vulnerable. Wendy's has flourished in the face of adversities plaguing the industry. Throughout the 70s, experts said that the fast-food industry was rapidly maturing. Analysts for *The Wall Street Journal* and *Business Week,* citing a "competitively saturated fast-food hamburger industry," predicted in the early 1970s that the Wendy's venture would not succeed. As they saw it, market saturation, rising commodity prices, fuel costs, and labor costs were already plaguing the fast-food industry.

3 Clearly unconcerned about such commentary, R. David Thomas pushed Wendy's relentlessly. Since it first started, Wendy's has opened an average

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This case was prepared by Richard Robinson, University of South Carolina, and William C. Craver, attorney-at-law.

of one restaurant every two days through 1979. It has become the first hamburger chain to top $1 billion in sales in its first 10 years.

History

4 R. David Thomas had an idea. He knew Americans love hamburgers. If he could develop a hamburger that was better than those currently offered, he believed that he could use it to establish a leadership position in the competitive fast-food hamburger market.

5 In November 1969, Thomas, an experienced restaurant operator and Kentucky Fried Chicken franchisee, began to put his idea into reality when he opened Wendy's first unit in downtown Columbus, Ohio. A year later, in November 1970, Wendy's opened its second unit in Columbus, this one with a drive-through pick-up window. In August 1972, Wendy's sold L. S. Hartzog the franchise for the Indianapolis, Indiana market; kicking off Wendy's rapid expansion into the chain hamburger business. Later the same year, Wendy's Management Institute was formed to develop management skills in managers, supervisors, area directors, and franchise owners. After five years, company revenues exceeded $13 million with net income in excess of $1 million. Sales for both company-owned and franchised units topped $24 million for the same period. In June 1975, the 100th Wendy's opened in Louisville, Kentucky. Three months later, Wendy's went public December 1976 saw Wendy's 500th open in Toronto, Canada. In 1977, Wendy's went national with its first network television commercial, making it the first restaurant chain to mount a national advertising campaign with less than 1,000 units. Eleven months later, Wendy's broke yet another record by opening its 1,000th restaurant in Springfield, Tennessee within 100 months of opening the first Wendy's in Columbus. In 1979, Wendy's signed franchise agreements for eight European countries and Japan, and opened the first European restaurant, company-owned, in Munich, West Germany. Also 1979 saw test marketing of a limited breakfast menu, a children's menu, and salad bars.

Wendy's developmental concept: The last 10 years

The menu

6 Wendy's management team believes that its limited menu has been a key factor contributing to Wendy's success. The idea was to concentrate on doing only a few things, but to do them better than anyone else. As a result, the aim was to provide the customer with a Cadillac hamburger that could be custom made to meet individual preferences.

7 The basic menu item was the quarter-pound hamburger made of only fresh, 100 percent beef hamburger meat converted into patties daily. This kept Wendy's out of head-on competition with McDonald's and Burger

King's one-tenth pound hamburger. If people desired a bigger hamburger, they could order a double (two patties on a bun) or a triple (three patties on a bun). Besides having just one basic menu item, the hamburger, Wendy's also decided to differentiate itself by changing their hamburger's design. Instead of the traditional round patty found in competing fast-food outlets, Wendy's patty was square and sized so that the edges would stick out over the edge of the round bun. The unique design alleviated the frequent complaint by most people that they were eating a breadburger. Other menu decisions included the following.

1. To offer different condiments to the customers—cheese, tomato, catsup, onion, lettuce, mustard, mayonnaise, and relish.
2. To provide a unique dairy product, the frosty—a cross between chocolate and vanilla flavors which borders between soft ice cream and a thick milkshake.
3. To serve a product which was unique in the fast-food market, chili.
4. To sell french fries because the public expected a hamburger outlet to offer them.

Facilities

8 Under Thomas's direction, the exterior style and interior decor of all Wendy's restaurants were built to conform with company specifications. The typical outlet was a freestanding one-story brick building constructed on a 25,000-square-foot site that provided parking for 35 to 40 cars (see Exhibits 1 and 2). There were some downtown storefront-type restaurants which generally adhered to the standard red, yellow, and white decor and design. Most of the freestanding restaurants contained 2,100 square feet, had a cooking area, dining room capacity for 92 persons, and a pick-up window for drive-in service (see Exhibit 3). The interior decor featured table tops printed with reproductions of 19th century advertising, Tiffany-styled lamps, bentwood chairs, colorful beads, and carpeting.

9 Generally, the strategy was to build a functionally modern building that would reflect the old-fashioned theme. Another plus for their building design was its flexibility. With only minor changes they could sell amost any type of food in the building. It would also be possible to change from the Gay 90s theme to any other theme in just a matter of days.

10 The most unique feature in their building design was the addition of the pick-up window. Wendy's was the first major restaurant chain to successfully implement the use of a pick-up window. Here, Wendy's was able to gain an advantage because their units could be smaller and at the same time handle the larger amount of business volume generated by using the pick-up window. The logic for implementing the use of the pick-up window was that people in their cars don't fill up tables, or take up a parking space. The result showed that on a square-foot basis, Wendy's units do more business than any other chain.

exhibit 1
Typical freestanding building design

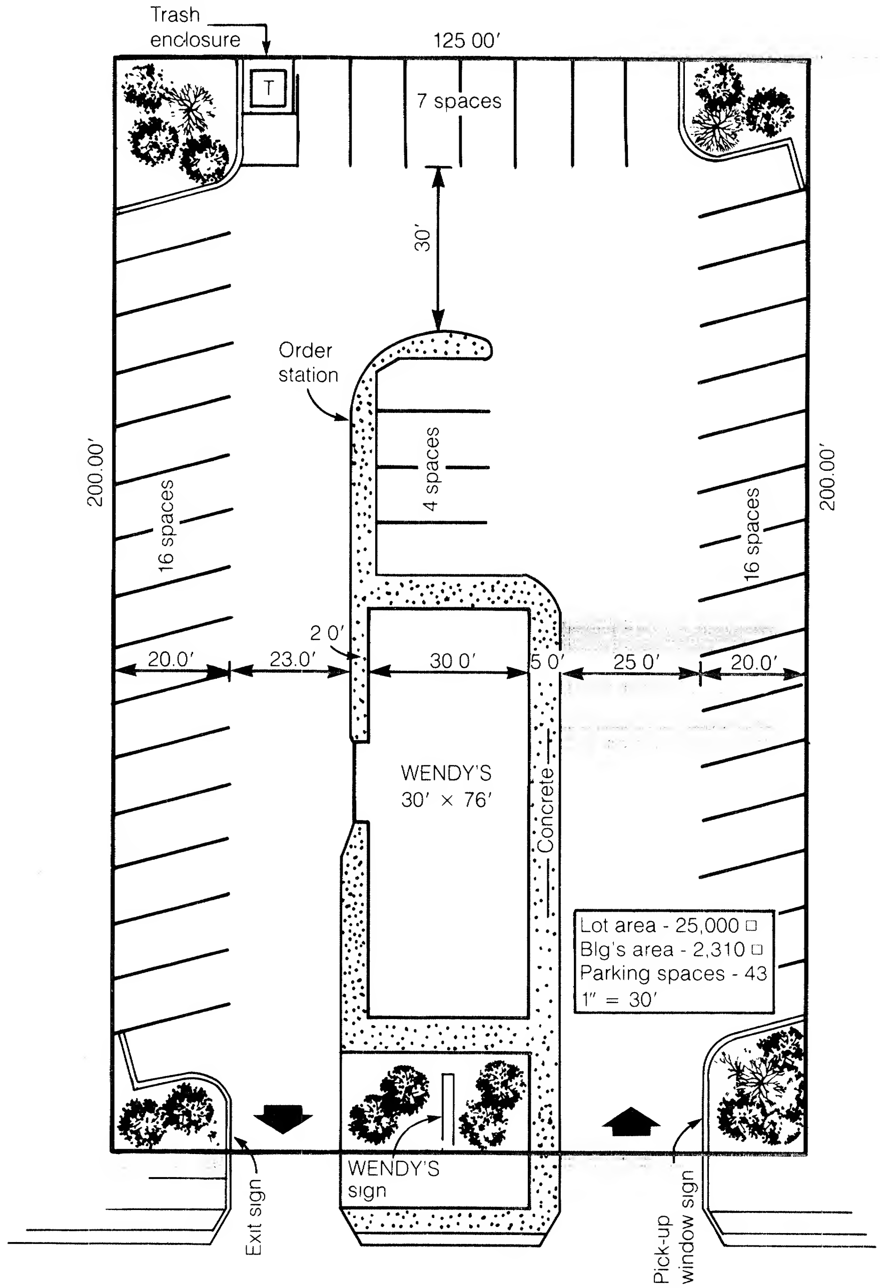
11 The building design has also contributed to what Michael J. Esposito, an investments analyst for Oppenheimer & Company, has called the most impressive part of the company's operation: the delivery system. In a report recommending Wendy's as an investment, Esposito wrote:

> In our judgment, the transaction time (time elapsed from when order is placed to its delivery to the customer) is the lowest in the industry, generally averaging about one minute. Utilizing a grill system where a constant flow of hamburgers is cooked at a relatively low temperature, a worker takes the hamburger off the grill, places it on a bun, adds the condiments ordered by the customer, assembles and wraps the sandwich. Another crew member supplies chili, french fries, or frosty, and another reviews the order and releases it to the customer.

The marketing strategy

12 In their new book, *The Chain-Restaurant Industry,* Earl Sasser and Daryl Wycoff stated:

exhibit 2
Wendy's typical site 1—typical lot layout for freestanding unit



Lot area, 25,000 square feet; building, 2,310 square feet; parking spaces, 43.

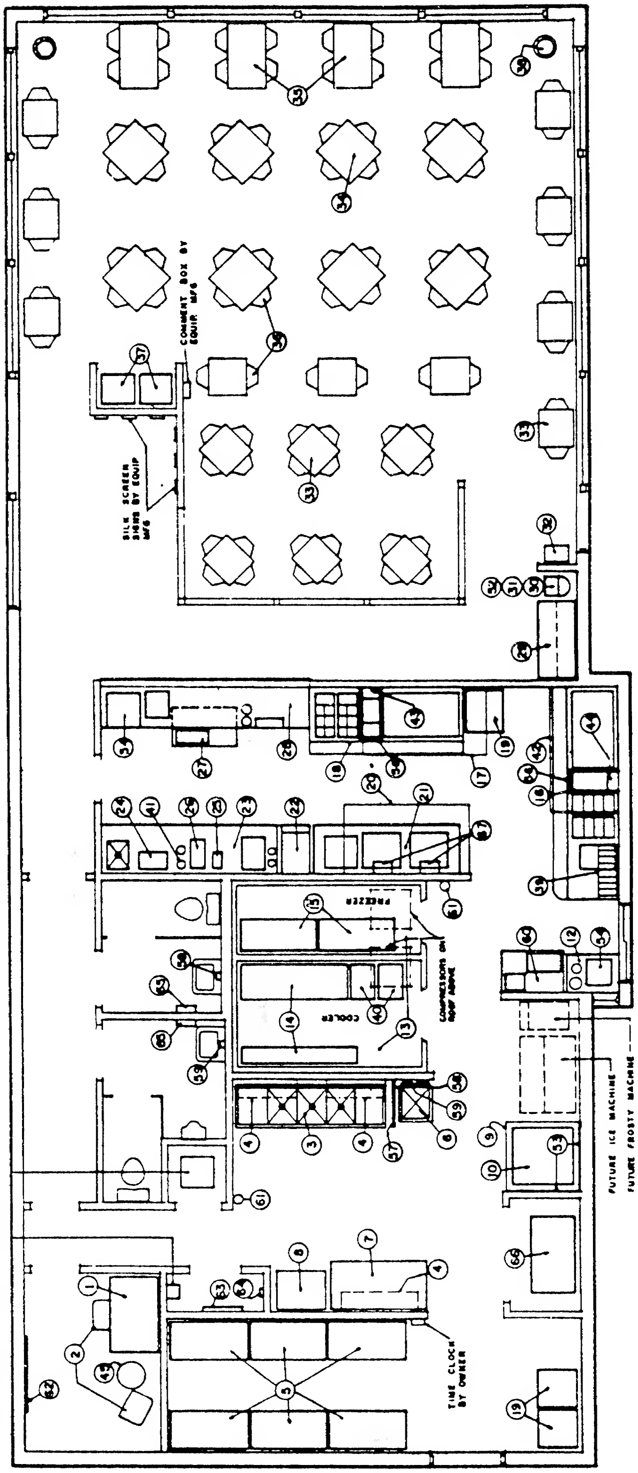


exhibit 3
Restaurant interior layout

Key:

1. Desk.
2. Chair.
3. Sink unit.
4. Wall shelving.
5. Wall shelving.
6. Sink unit.
7. Work table.
8. Hamburger patty-making machine.
9. Exhaust canopy system
10. Range top.
11. Open number.
12. Cashier counter assembly.
13. Walk-in cooler/freezer.
14. Wire shelving.
15. Frozen french fry storage platform.
16. Custom cooks counter assembly.
17. Exhaust canopy system.
18. Custom cook.
19. Bun rack.
20. Exhaust canopy system.
21. Custom fry station assembly.
22. Frosty machine.
23. Rear counter assembly.
24. Coffeemaker.
25. Tea machine.
26. Hot chocolate machine.
27. Ice and drink machine.
28. Front counter assembly.
29. Condiment station.
30. High chair.
31. Booster chairs.
32. Water fountain.
33. Pedestal tables.
34. Pedestal tables.
35. Pedestal tables.
36. Side chairs.
37. Waste containers.
38. Costumers.
39. Condiment holder.
40. Meat racks.
41. Marshmallow holder.
42. Exhaust canopy system (fire protection)
43. Custom paper holder.
44. Custom paper holder.
45. Floor safe.
46. Litter receptacle.
47. Tiffany-style light fixtures.
48. Carpet.
49. Wall covering.
50. Beads.
51. Installation package.
52. Booster chair hanger.
53. Stainless wall panel.
54. Cash registers.
55. Open number.
56. Bun cabinet.
57. Stainless partition.
58. Towel dispenser.
59. Soap dispenser.
60. Ice and drink machine.
61. Fire extinguishers.
62. Coat hook bar.
63. Broom holder.
64. Hose holder.
65. Hand dryers.
66. Syrup tank rack.
67. French fry computers.

> The Wendy's strategy was described by one analyst as "selling better hamburgers than McDonald's or Burger King at a cheaper price per ounce." As he commented, it takes no more labor to prepare a larger hamburger at a higher price.

13 To support the higher-priced hamburger, Wendy's marketing strategy has been to stress the freshness and quality of their product. The objective of this strategy is to target Wendy's for the world's fastest growing market segment. By offering a freshly ground, made-to-order hamburger as well as stylish, comfortable decor, Wendy's was aiming squarely at a key segment of the population: young adults with a taste for better food. With the post-World War II babies reaching their 20s and 30s, those young adults have been expanding faster than any other age group. As a result, it is thought that Wendy's success is coming not so much at the expense of the other burger chains, but from having selected a special niche in the otherwise crowded market. Most agree that Wendy's basically expanded the market. Statistics from customer surveys bear out the claim. Fully 82 percent of all Wendy's business comes from customers over 25, an unusually old market for any fast-food chain. By contrast, McDonald's generated 35 percent of its revenues from youngsters under 19.

14 Wendy's advertising efforts have emphasized nationwide television advertising to attract this young adult market. Since 1974, Wendy's "Hot 'n' Juicy" advertising theme has been central to this effort. In the late 1970s, with its position established, Wendy's national advertising started focusing on new market segments like dinner after 4 P.M. and family meals on weekends. Apparently feeling the Hot 'n' Juicy theme had served its purpose, Wendy's adopted a new advertising theme: "There ain't no reason to go anyplace else."[1] This theme has sparked considerable attention, particularly a negative reaction to the word *ain't* and the phrase's double negative.

Franchising

15 In 1972, Wendy's management made the decision to become a national chain as quickly as possible, which meant growing through franchising. The franchises were awarded on an area basis rather than single-store franchises. As a result, Wendy's 10 largest franchise owners operated a total of 406 restaurants by 1979. The franchise agreements were among the most straightforward in the restaurant industry and are deliberately designed to establish a fair business relationship. They specify the number of units to be opened within a certain time frame, the area to be developed, a technical assistance fee, and a royalty of 4 percent of gross sales. They also stipulated that 4 percent of gross sales be spent for local and national advertising.

[1] A recent article in *The Wall Street Journal* offered another explanation "Wendy's ads showed diners biting into its hot and juicy hamburgers and them mopping juice from their chins. But some people thought the image projected by the ads was hot and greasy. Many franchises quit advertising, in effect voting no confidence in the company's marketing plan." (July 8, 1980, p. 29.)

Wendy's operated no commissaries and sold no food, fixtures, or supplies to franchise owners.

16 To support their growing network of franchised restaurants, Wendy's franchise operations department maintains a staff of 50 franchise area supervisors. These supervisors are the company's operations advisors to the franchise owners. They are charged with ensuring that Wendy's quality standards are met throughout the entire franchise network.

17 Wendy's also provided the following services to their franchisees.

1. Site approval procedures for locations.
2. On-site inspection and evaluation by a staff representative.
3. Counseling in business planning.
4. Drawing and specifications for buildings.
5. Training for franchisees at Wendy's headquarters.
6. Advice on supplies from suppliers selected by Wendy's and assistance in establishing quality control standards and procedures for supplies.
7. Staff representatives to help in the opening of each restaurant.
8. Assistance in planning opening promotion and continuing advertising, public relations, and promotion.
9. Operations manual with information necessary to operate a Wendy's restaurant.
10. Research and development in production and methods of operations.
11. Information on policies, developments, and activities by means of bulletins, brochures, reports, and visits of Wendy's representatives.
12. Paper-goods standards.
13. National and regional meetings.

18 The criteria used by Wendy's for franchisee selection is basically simple, but strictly adhered to. They look for good proven business ability. The applicant must demonstrate that he or she is interested in making profits and does not mind getting involved. Wendy's did not make their profits by selling goods and services to their franchisees. Their income came from the restaurants' sales volume. Therefore, the franchisee must be able to build sales.

19 Wendy's operates company-owned restaurants in 26 markets around the following cities:

Columbus, Ohio	33
Cincinnati, Ohio	20
Dayton, Ohio	26
Toledo, Ohio	12
Atlanta, Georgia	35
Tampa, Sarasota, St. Petersburg, Clearwater, Florida	22
Jacksonville, Florida	15
Daytona Beach, Florida	4
Detroit, Michigan	20
Portland, Oregon	10
Reno, Nevada	6
Greensboro, North Carolina	10
Indianapolis, Indiana	15
Dallas/Ft. Worth, Texas	26
Houston, Texas	25
Oklahoma City, Oklahoma	12
Tulas, Oklahoma	12
Memphis, Tennessee	13
Louisville, Kentucky	14
Syracuse, New York	10
Harrisburg, Pennsylvania	22
Philadelphia, Pennsylvania	20
Virginia Beach, Virginia	15
Charleston, West Virginia	14
Parkersburg, West Virginia	20
Munich, West Germany	2

Other than Detroit, no franchises exist in these markets.

20 At the end of 1979, there were 1,385 franchised restaurants operated by 161 franchise owners in 47 states and 3 foreign countries. Wendy's employs a staff of 50 franchise area supervisors to ensure that its quality standards are met throughout the entire franchise network.

21 In a report to the Securities and Exchange Commission, Wendy's discussed the current state of its franchise program and described the franchise owners relationship with the company:

> Although franchised areas exist in all states except three, areas of some states remain unfranchised. In addition, most franchise owners have the right to build more units in their franchised areas than had been constructed at December 31, 1979. At that date, no franchise owner had more than 88 stores in operation. Several franchise owners operate restaurants in more than one state.
>
> The rights and franchise offered by the company are contained in two basic documents. A franchise owner first executes a development agreement. This document gives the franchise owner the exclusive right to select proposed sites on which to construct Wendy's Old Fashioned Hamburgers restaurants within a certain geographic area (the franchised area), requires the submission of sites to the company for its acceptance, and upon acceptance of a proposed site by the company, provides for the execution of a unit franchise agreement with the company to enable the franchise owner to construct, own, and operate a Wendy's Old Fashioned Hamburgers restaurant upon the site. The development agreement provides for the construction and opening of a fixed number of restaurants within the franchised area in accordance with a development or performance schedule. Both the number of restaurants and the development and performance schedules are agreed upon by the franchise owner and the company prior to the execution of the development agreement. The development agreement also grants a right of first refusal to the franchise owner with respect to the construction of any additional restaurants in the franchised area beyond the initially agreed to number.
>
> The development agreement requires that the franchise owner pay the company a technical assistance fee. The technical assistance fee required by newly executed development agreement is currently $15,000 for each franchise restaurant which the franchise owner has agreed to construct. Under earlier forms of the development agreement or franchise agreements this fee was either $5,000, $7,500, or $10,000. However, approximately 12 existing franchise owners have the right under certain circumstances to receive additional franchise areas on the basis of the earlier $10,000 fee.
>
> The technical assistance fee is used to defray the cost to the company of providing to its franchise owners site selection assistance; standard construction plans, specifications and layouts; company review of specific restaurant site plans; initial training in the company's restaurant systems; and such bulletins, brochures, and reports as are from time to time published regarding the company's plans, policies, research, and other business activities.

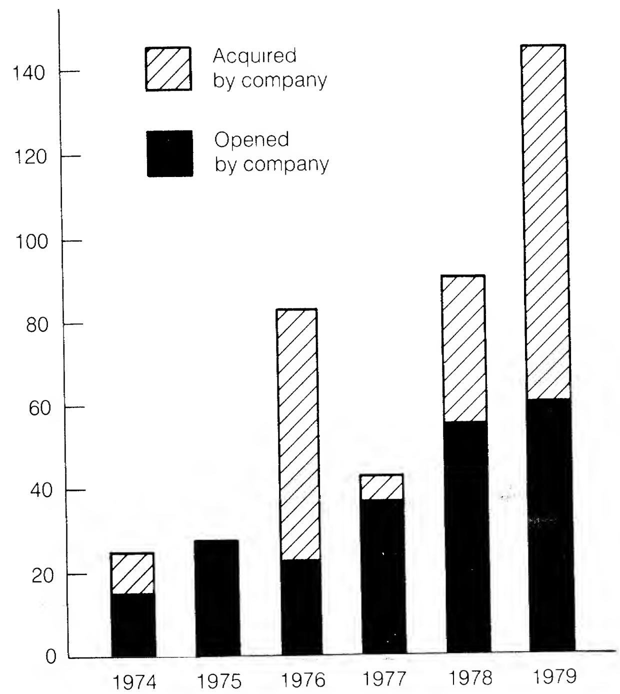
22 From time to time, the company has reacquired franchised operations. A summary of these acquisitions is presented in Exhibit 4. In 1979, the com-

exhibit 4

Acquisition date	Company acquired	Restaurants in operation	Location	Accounting treatment	Common shares issued/ purchase price
1. 7/31/76	Wendy's Management, Inc. and subsidiaries	40	Atlanta, Georgia Indianapolis, Indiana Louisville, Kentucky Jacksonville, Florida	Purchase	733,195
2. 10/1/77	Wendy's Old Fashioned Hamburgers of New York, Inc.	5	Syracuse, New York	Purchase	Immaterial
3. 6/30/78	Wendy's of West Virginia, Inc.	33	West Virginia Eastern Kentucky Southeast Ohio	Pooling	535,000
4. 9/30/78	Springfield Management Company Inc. and Dakota Land Corp.	6	Springfield, Ohio Richmond, Indiana	Pooling	39,294
5. 5/26/79	1620 South Atlantic, Inc. Forsyth, Inc. RR&WW, Inc. Reaves & Reaves Restaurants, Inc.	14	Greensboro, North Carolina Winston-Salem, North Carolina Daytona Beach, Florida	Pooling	268,900
6. 5/30/79	Wendcorp of Nevada, Inc. Wendcorp of Portland, Inc.	16	Reno, Nevada Portland, Oregon	Pooling	245,815
7. 8/31/79	Susquehanna Food Services, Inc.	40	Southeastern Pennsylvania and northern Delaware	Pooling	508,861
8. 11/30/79	Wendy's of Virginia, Inc.	14	Southeastern Virginia	Purchase	$5,520,000

pany adopted a rather aggressive approach to franchise acquisition. Of 145 new company-owned operations in 1979 (representing a 50 percent increase during the year), 84 were acquired from franchisees. This major shift to company-owned restaurant growth away from franchised growth reflects the concern for system-wide control of quality as well as the increasing competition for available locations. Exhibit 5 illustrates the emphasis on company-owned growth since 1974. Granting large territorial franchises rather than single-outlet franchises was similarly practiced by Burger King in its formative stages. At Burger King, this led to franchise empires that were bigger than parent company operations. Wendy's emphasis on company-owned growth may well be intended to avoid the problem that led to Burger King's decline in the late 1960s.

exhibit 5
Growth in company-operated restaurants



Finances

23 Wendy's revenues (see Exhibit 6) increased steadily over the past five years. Net income dropped in 1979 compared to 1978, but Thomas explains:

> During 1979, we were informed by the U.S. Department of Labor that a review of company labor practices for a three-year period indicated that certain company policies had not been uniformly adhered to and, as a result, the company was not in full compliance with the Fair Labor Standards Act.

exhibit 6

WENDY'S INTERNATIONAL, INCORPORATED
Consolidated Statement of Income
For the Years Ended December 31, 1975–1979

	1979	*1978*	*1977*	*1976*	*1975*
Revenue:					
Retail operations	$237,753,097	$198,529,130	$130,667,377	$71,336,626	$35,340,665
Royalties	30,564,613	23,396,211	11,810,277	4,655,432	1,567,008
Technical assistance fees	2,822,500	3,540,000	2,510,000	1,560,000	622,500
Other, principally interest	2,903,261	2,685,909	1,802,691	965,521	246,901
Total revenues	274,043,471	228,151,250	146,790,345	78,517,579	37,777,074
Costs and expenses:					
Cost of sales	146,346,806	113,812,874	72,482,010	40,509,285	19,629,179
Company restaurant operating costs	51,193,050	43,289,285	28,088,460	14,348,150	7,292,391
Department of labor compliance review	3,800,000				
Salaries, travel, and associated expenses of franchise personnel	4,187,399	3,148,532	1,936,877	1,156,493	622,879
General and administrative expenses	15,741,592	13,292,845	8,191,394	4,137,226	2,581,166
Depreciation and amortization of property and equipment	7,355,818	5,444,092	3,767,259	2,240,215	799,876
Interest	4,357,973	3,771,878	3,215,432	2,583,876	995,410
Total expenses	232,982,638	182,759,506	117,681,432	64,975,245	31,920,901
Income before income taxes	41,060,833	45,391,744	29,108,913	13,542,334	5,856,173
Income taxes:					
Federal:					
Current	15,583,700	18,324,600	12,052,200	5,784,600	2,926,700
Deferred	1,303,200	1,020,800	323,700	(19,600)	(501,900)
	16,886,900	19,345,400	12,375,900	5,765,000	2,424,800
State and local taxes	1,077,500	1,559,700	1,296,200	694,400	298,800
Total income taxes	17,964,400	20,905,100	13,672,100	6,459,400	2,723,600
Net income	$ 23,096,433	$ 24,486,644	$ 15,436,813	$ 7,082,934	$ 3,132,373
Net income per share	$1.54	$1.63	$1.04	$.57	$.29
Weighted average number of common shares outstanding	14,970,526	15,017,708	14,855,503	12,525,294	10,645,694
Dividends per common share	$.40	$.14	$.125	$.004	$.001

Source: Wendy's International, form 10-K, 1979.

Based on this review and the company's own investigation, we have determined that $3,800,000 should be accrued and charged against 1979 pretax income. Had this charge not been made, 1979 net income would have been $25,096,000, an increase of 8 percent over the $23,215,000 originally reported a year earlier. We believe company labor practices now comply with both company policy and with the act and, in addition, future compliance will not materially affect net income in 1980 and ensuing years.

24 Whether the cost of labor compliance was the only cause of the abrupt slowdown in Wendy's steady increase in revenue and profit is questionable. Several factors suggest that Wendy's, after a decade of rapid growth, is reaching the limits of its current capabilities.

25 The heart of Wendy's success has been its streamlined, limited menu with primary emphasis on a quality hamburger. Since 1977, beef prices have soared, as shown in Exhibit 7. And while Wendy's has responded with tighter controls and a series of price increases just under 15 percent for 1979 alone (see Exhibit 8), this has still contributed to a decline in profitability.

exhibit 7
Yearly average meat price per pound for company-owned stores

1969	$.59	1975	$ .69
1970	.62	1976	.72
1971	.64	1977	.72
1972	.67	1978	1.02
1973	.90	1979	1.29
1974	.74		

exhibit 8
Percentage price increases for hamburgers

1/1/77	0.6%	10/22/78	0.15%
3/1/77	0.3	10/29/78	0.10
12/10/77	6.0	12/17/78	3.40
3/19/78	3.0	1/14/79	3.06
4/16/78	2.5	2/25/79	3.60
5/21/78	1.8	4/8/79	0.10
7/23/78	1.2	4/15/79	0.03
10/1/78	1.7	12/16/79	4.45

26 Further evidence suggest that Wendy's may be reaching a plateau in its historical pattern of growth. The average sales per restaurant, which has climbed steadily from $230,000 in 1970 to $688,800 in 1978, declined significantly in 1979 at both company-owned and franchised restaurants as shown in Exhibit 9. The impact on the parent company was felt in every revenue

exhibit 9
Average sales per restaurant

	1979		*1978*	
	Amount	*Percent change**	*Amount*	*Percent change**
Company	$624,000	(2.9)	$642,900	14.3
Franchise	618,800	(12.4)	706,000	11.7
System-wide	620,000	(10.0)	688,800	13.0

* Percent increase (or decrease) over the same figure for the previous year.

category as shown in Exhibit 10. Wendy's continued to experience increased retail revenue (company-owned stores) and royalties (from franchises based on a percent of sales), but at a drastically slower rate. And, for the first time, Wendy's experienced a decrease in technical assistance (franchise) fees.

exhibit 10
Changes in revenue from 1978 to 1979

	1979		*1978*	
	*Amount**	*Percent†*	*Amount*	*Percent*
Retail operations	$39,224,000	19.8	$67,862,000	51.9
Royalties	7,168,000	30.6	11,586,000	98.1
Technical assistance fees	(718,000)	(20.3)	1,030,000	41.0
Other, principally interest	(217,000)	(8.1)	883,000	49.0

* Absolute dollar increase (or decrease) over the previous year.
† Percent increase (or decrease) over the previous year.

27 Other evidence of a slowdown in Wendy's growth can be seen in the rate of new store openings. For the first time in its history, Wendy's experienced a decline in the rate of new store openings, as shown in Exhibit 11.

exhibit 11
New restaurant openings: 1979 versus 1978

	*Company**		*Franchise*		*System-wide*	
	1979	*1978*	*1979*	*1978*	*1979*	*1978*
Open at beginning of year	348	271	1059	634	1407	905
Opened during the year	71	77	340	425	411	502
Purchased from franchise owners	14	—	(14)	—	—	—
Total open at end of year	433	348	1385	1059	1818	1407
Average open during year	381	309	1235	828	1616	1137

* Restaurants acquired from franchise owners in poolings of interest have been included since date of opening.

28 While revenue and profitability growth slowed in 1979, Thomas is confident this is only temporary. Feeling strongly that Wendy's is in a good position to finance continued growth, Thomas offered the following observation:

> While construction money is more difficult to obtain than in the last few years, lines of credit already arranged guarantee financing of 1980 company plans to open 60 or more restaurants. We also anticipate exploring avenues of long-term debt to finance our growth beyond 1980. We believe that with $25 million of long-term debt, exclusive of capitalized lease obligations, and over $100 million in shareholders' equity, we have substantial untapped borrowing power.

Exhibit 12 summarizes Wendy's balance sheet for 1978 and 1979.

exhibit 12

WENDY'S INTERNATIONAL, INCORPORATED
Consolidated Balance Sheets
For the Years Ended December 31, 1978, and 1979

	1979	*1978*
Assets		
Current assets:		
Cash	$ 2,285,180	$ 1,021,957
Short-term investments, at cost, which approximates market, including accrued interest	12,656,352	27,664,531
Accounts receivable	4,902,746	3,248,789
Inventories and other	2,581,528	1,855,313
Total current assets	22,425,806	33,790,590
Property and equipment, at cost Schedule 5:		
Land	30,916,049	23,906,365
Buildings	40,784,581	30,049,552
Leasehold improvements	16,581,947	8,954,392
Restaurant equipment	34,052,952	24,461,860
Other equipment	9,722,666	8,413,363
Construction in progress	1,751,788	2,027,570
Capitalized leases	21,865,829	18,246,427
Total property and equipment before depreciation	155,675,812	116,059,529
Less accumulated depreciation and amortization	(20,961,702)	(13,543,473)
Total property and equipment	134,714,110	102,516,056
Cost in excess of net assets acquired, less amortization of $699,410 and $481,162, respectively	8,408,788	5,207,942
Other assets	7,152,131	2,377,648
Total cost over net assets and other assets	15,560,919	7,585,590
Total assets	$172,700,835	$143,892,236

Wendy's future

29 Addressing Wendy's stockholders in early 1980, R. David Thomas offered the following assessment of Wendy's first 10 years:

> We are proud to be marking the 10th anniversary of Wendy's International, Inc. Just 10 years ago, in November 1969, we opened the first Wendy's Old Fashioned Hamburgers restaurant in downtown Columbus, Ohio. Now, after a decade of explosive growth, there are Wendy's quick service restaurants in 49 of the 50 states and in Canada, Puerto Rico, Germany, and Switzerland.
>
> At year-end 1979, thee were 1,818 Wendy's restaurants in operation, 411 more than at the close of 1978. Of the 433 company-operated restaurants, 84 were acquired franchise owners during 1979. It was a year of progress for our international expansion program as we opened our first restaurants in

exhibit 12 ***(concluded)***

Liabilities and Shareholders' Equity	*1979*	*1978*
Current liabilities:		
Accounts payable, trade	$ 10,174,980	$ 11,666,272
Federal, state, and local income taxes		7,839,586
Accrued expenses:		
Administrative fee		664,770
Salaries and wages	2,368,244	1,970,977
Interest	433,540	369,603
Taxes	1,932,192	1,498,521
Department of Labor compliance review	3,800,000	
Other	1,576,851	739,588
Current portion, term debt, and capitalized lease obligations	3,891,247	2,781,671
Total current liabilities	24,177,054	27,530,988
Term debt, net of current portion	25,097,688	15,308,276
Capital lease obligations, net of current portion	18,707,838	15,130,617
	43,805,526	30,438,893
Deferred technical assistance fees	1,995,000	2,117,500
Deferred federal income taxes	2,027,604	664,300
Shareholders' equity:		
Common stock, $.10 stated value; authorized: 40,000,000 shares; issued and outstanding: 14,882,614 and 14,861,877 shares, respectively	1,488,261	1,486,188
Capital in excess of stated value	34,113,173	33,962,916
Retained earnings	65,094,217	47,691,451
Total shareholders' equity	100,695,651	83,140,555
Total liabilities and shareholders' equity	$172,700,835	$143,892,236

Source: Wendy's International, form 10-K, 1979.

Europe and entered into agreements for development of Japan, France, Belgium, Luxembourg; the Netherlands, Switzerland, Spain, Germany, and the United Kingdom.

During 1979, the company established a research and development department which is testing a number of potential menu items. The salad bar, which was tested in our Columbus, Ohio market, had been introduced into 171 restaurants by year-end.

In 1979, our industry was faced with major challenges, such as inflation and energy problems. Higher labor costs and rising beef prices affected Wendy's profitability, and depressed profits for our entire industry. The minimum wage, which affects 90 percent of our employees, increased in January 1979 and January 1980. Ground beef prices increased to an average of $1.29 per pound in 1979, 79 percent higher than the 1977 average price. During 1979, we minimized our retail price increases, with the goal of in-

creasing our market share. This strategy, coupled with more aggressive marketing, helped rebuild customer traffic in the latter part of the year. Although holding back on price increases affected our margins, we believe it was appropriate and that margins benefited by our cost efficiencies, especially in purchasing and distjibution.

During 1979, we remained flexible and open to changing customer needs and attitudes, and we continued to take the steps necessary to achieve and support future growth and profitability as we—

Tested and implemented a highly successful salad bar concept.

Tested a breakfast concept and other menu items.

Began development of the European and Japanese markets.

Initiated a new marketing program designed to increase dinner, and weekend business.

Prepared to open another 250 to 300 Wendy's restaurants system-wide in 1980.

30 And setting the tone for Wendy's in the 1980s, Thomas said:

> We are aware, as we enter our second decade, that we have achieved a unique position in a highly competitive industry. It was no less difficult and competitive 10 years ago than it is today, we believe, than it will be 10 years from now. We intend to build further on our achievement of being recognized as a chain of high-quality, quick-service restaurants. We will continue to produce fresh, appealing, high-quality food; price it competitively; and serve it in a clean, attractive setting with employees who are carefully selected, well-trained, and responsive to our customers.

31 Similar to the way they questioned R. David Thomas's venture into the hamburger jungle in 1970, several business writers have once again begun to question Wendy's future. Illustrative of this is the following article that recently appeared in *The Wall Street Journal*:

> Wendy's International Inc. is making changes it once considered unthinkable.
>
> Wendy's faced the choice confronting many companies when the initial burst of entrepreneurial brilliance dims: Should it stick with the original concept and be content with a niche in a bigger market, or should it change and attempt to keep growing? Wendy's chose to revamp its operations. It is adding salad bars, chicken and fish sandwiches, and a children's meal to its menu, adopting a new advertising strategy and considering whether to alter the appearance of its restaurants.
>
> Some observers predict Wendy's will regret the quick changes. "This is a company that was able to convince a certain segment of the country it had a different taste in hamburgers," says Carl De Biase, an analyst with Sanford C. Bernstein & Co. in New York. "They've achieved their mandate, and anything they do now is just going to screw up the concept."
>
> But Robert Barney, Wendy's president and chief executive officer, says the company is "in some very difficult times right now." Among the problems: discontented franchise holders and the likelihood that beef prices will

rise sharply again in the second half. Barney says Wendy's doesn't even "have the luxury of waiting to see" how each change works before moving to the next one.

This spring, shortly after the changes began, Thomas resigned as chief executive saying he wanted more time for public relations work and community affairs. Thomas, who is 47 years old and will continue as chairman, had been closely identified with the old ad campaign and with company resistance to broadening the menu.

The company has been doing a little better so far this year, and franchisees say they're much more optimistic. The menu changes, they say, were long overdue. "It had been suggested to everyone in the company," says Raymond Schoenbaum, who operates 33 Wendy's outlets in Alabama and Georgia. "But the mentality wouldn't allow menu diversification before. It had to be forced on them."

Barney concedes that prior to last year "we never did a lot of planning." But that has been remedied, he says, partly with a "research and development department" that will examine new menu prospects.

Not everyone believes that tinkering with the menu will bring back customers and profits. Edward H. Schmitt, president of McDonald's, predicts an image problem for Wendy's and maintains that the company will lose the labor advantage it held over other fast-food outlets. He adds that McDonald's tried and abandoned salad bars. "It's practically a no-profit item," he says, "and it's a high-waste item."

Some franchises complain that the new children's meal, called Fun Feast, will draw the company into a can't-win competition with McDonald's and Burger King for the children's market, which Wendy's has avoided so far. "Every survey we have says we shouldn't go after that market," a franchisee reports. "Our chairs aren't designed for kids to climb on, and our carpet isn't designed for kids to spill ketchup on."

But Barney insists that Fun Feast isn't intended to attract children. He says Wendy's is trying to remove the adults' reason for not coming to the restaurant. "Where we tested it," he says, "we didn't sell so many of them but we did see an increase in adult traffic."

Wendy's may evolve from a sandwich shop into a more generalized quick-service restaurant that doesn't compete as directly with McDonald's and Burger King. "We're going to be between" McDonald's and quick-service steakhouses, says Schoenbaum, the Georgia and Alabama franchise holder.

To this end, Schoenbaum says, Wendy's will reduce the abundance of plastic fixtures in its restaurants and perhaps cut down on the amount of glass. He says the glass makes Wendy's a pleasant, brightly lit lunch spot but doesn't create a good atmosphere for dinner.

Wendy's officials confirm that they are considering altering the appearance of their restaurants, but they aren't specific. And as for whom Wendy's competes with, Barney says: "We're in competition with anywhere food is served, including the home."[2]

---

[2] "It's Vigor Lost, Wendy's Seeks a New Niche," *The Wall Street Journal,* July 8, 1980, p. 29.

case 2

The Kellogg Company and presweetened cereals

History

1 W. K. Kellogg began producing ready-to-eat cereals in Battle Creek, Michigan before the turn of the century. In 1876, his brother Dr. John H. Kellogg became superintendent of the Battle Creek Sanitarium.[1] W. K. Kellogg served as business manager. He also spent considerable time attempting to develop cereal foods that would be nutritious and palatable for patients.

2 Wheat flakes were developed in 1894 during a series of experiments conducted by both men. Boiled wheat dough was run through rollers to produce thin sheets of wheat. These sheets were then toasted and ground into a meal. Accidentally, one batch of cooked wheat was left exposed to the air for more than a day. The brothers decided to run this batch through the rollers even though it was no longer fresh. To their pleasant surprise, the rolls discharged a flake for each individual berry instead of a sheet of wheat. This period of waiting had allowed moisture in the wheat to be distributed evenly through the batch and through each berry, thus resulting in individual flaking. Subsequently, wheat flakes were introduced at the sanitarium and proved to be popular with the patients.

3 In 1898, corn flakes were developed.[2] Initially, they were made from the whole kernal. Acceptance was limited. W. K. Kellogg discovered a much better flake could be produced by using only the grit or heart of the corn and by adding malt flavoring.

4 The Kellogg brothers believed that grains were excellent foods. Their grain cereal products were well received at the sanitarium. Many former patients wrote for the foods they had been served during their stay.

5 During this period, Dr. John H. Kellogg started a food manufacturing company, the Sanitas Food Company. Later he established the Sanitas Nut Food Company, and in 1899 the two firms were combined into a copartnership with W. K. Kellogg as general manager.

6 In 1902, W. K. announced that he was leaving to form his own company. He wanted to produce and sell corn flakes, employing aggressive production and marketing proposals designed to stimulate growth of the business. His

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[1] Public Affairs Department, Kellogg Company, *The History of Kellogg's* (Battle Creek, Mich., 1979), p. 1. At that time, this sanitarium was known as the Western Health Reform Institute.

[2] Ibid., p. 1.

brother would not agree to such ideas and W. K. wanted to try his own methods.

7 That same year, a fire destroyed the Battle Creek Sanitarium. W. K. Kellogg delayed his business plans to help his brother rebuild the sanitarium. Four years later, the Battle Creek Toasted Corn Flakes Company came into existence on February 19, 1906.[3] Initial employment was 25 people.[4]

8 The new firm grew rapidly. More than 1 million cases of cereal were sold in 1909. In that same year, the firm changed its name to Kellogg Toasted Corn Flake Company. In 1911, the advertising budget reached $1 million.[5]

9 By 1918, Kellogg cereals were becoming popular outside the United States. U.S. troops carried Kellogg cereals to Europe during World War I (1914–1918) and export of the company's products to Canada and England had started. Kellogg opened production facilities in Canada during 1924 and in Australia in 1928. A plant in England was opened in 1938. In 1978, the company had 49 operations and 20 countries throughout the world, offering both ready-to-eat cereals and a wide variety of other food products.[6]

10 Today, Kellogg is the largest ready-to-eat cereal manufacturer in the United States. Its 1978 sales of $1.7 billion yielded a net profit of $145.1 million. It has a commanding 42 percent share of the market. Its nearest competitors are General Mills, General Foods, and Quaker Oats, with market shares of 19, 16.3, and 8 percent, respectively. Kellogg employed 20,905 persons in 1978.[7]

11 Kellogg's ready-to-eat cereal line available in the United States presently consists of 21 different brands. These are shown in Exhibit 1. About 75

exhibit 1
Kellogg's ready-to-eat cereal available in United States, 1978

All-Bran	Frosted Mini-Wheats
Apple Jacks	Kellogg's Frosted Rice
Bran Buds	Pep Wheat Flakes
Cocoa Krispies	Product 19
Concentrate	Kellogg's Raisin Bran
Kellogg's Corn Flakes	Rice Krispies
Corn Snaps	Special K
Kellogg's Country Morning	Kellogg's Sugar Frosted Flakes of Corn
Cracklin Bran	Sugar Corn Pops
Kellogg's 40% Bran Flakes	Sugar Smacks
Froot Loops	Toasted Mini-Wheats

Source: Kellogg Company, *Kellogg's: A Quality Story,* 1978, p. 4.

[3] Ibid., p. 2.

[4] Kellogg Company, *Annual Report,* 1951, p. 1.

[5] *History of Kellogg's,* p. 2.

[6] Kellogg Company, *Kelloggs: A Quality Story* (Battle Creek, Mich., 1978), p. 10.

[7] "Kellogg: Still the Cereal People," *Business Week,* November 26, 1979, p. 80; Kellogg Company, *Annual Report,* 1978, p. 29; and Standard & Poor's, *Industry Surveys,* October 1979, p. F31.

percent of total revenues and 80 percent of total profits are derived from the sale of cereals. Kellogg's leading brands and their market shares in 1978 are shown in Exhibit 2. Total advertising outlays in 1978 were $114.9 million.[8] Financial statements for 1978 and other pertinent data are shown in Exhibit 3.

exhibit 2
Kellogg's leading brands, 1978

	Market	
Brand	*Rank*	*Share percent*
Corn Flakes	1	7.5
Frosted Flakes	3	6.0
Raisin Bran	4	4.7
Rice Krispies	5	4.5
Froot Loops	11	2.5

Source: *Business Week,* November 26, 1979, p. 80.

12 While predominantly a cereal manufacturer, Kellogg began some diversification of its product line in 1969 with the acquisition of Salada Foods, Ltd. Salada produces tea, dessert mixes, and other food products which are marketed in the United States. Instant tea produced by Fearn International, Inc. is distributed by both Salada and Fearn.

13 In 1970, Kellogg acquired Fearn International, Inc. Fearn produces and distributes under the Le Gout label. In addition to instant tea, its products include soup bases, condensed soups, gelatin desserts, puddings, pie fillings, canned gravies, and sauces. The firm also heats and serves entries for restaurant and institutional users in the United States.

14 In 1976, the acquisition of Mrs. Smith's Pie Company resulted in the addition of frozen pies and pie shells to Kellogg's product line. In some areas, fresh-baked pies and other pastries are produced and distributed. The Mrs. Smith organization also produces frozen waffles under the Eggo brand for sale in the United States.

15 Pure Packed Foods, Inc., acquired in 1977, has as its primary product line a nondairy whipped topping which is sold under private label to grocery distributing organizations in the United States.

16 Kellogg Salada Canada, Inc. produces and markets tea, frozen pies, waffles, pizza, nonprescription cold remedies, potato products, preserves and spreads, gelatin desserts, drink mixes, pie fillings, ready-to-eat cereals, and toaster pastries.

17 Other products produced and marketed by the Kellogg Company in limited areas outside the United States include rice, packaged beans and dried soups, drink mixes, specialty snack breads, ice-cream cones, snacks, bread

[8] Kellogg Company, *Form 10-K,* annual report, 1978, p. 18.

exhibit 3
Kellogg Company 1978 financial statements and five-year financial review

KELLOGG COMPANY AND SUBSIDIARIES
Consolidated Balance Sheet
For the Years 1977 and 1978
($ millions)

	December 31, 1978	*December 31, 1977*
Assets		
Current assets:		
Cash, including certificates of deposit of $58.5 ($38.2 in 1977)	$ 67.6	$ 48.8
Marketable securities, at cost which approximates market	36.0	32.4
Accounts receivable, less allowances of $1.8 ($1.5 in 1977)	115.8	108.7
Inventories:		
Raw materials and supplies	110.8	98.6
Finished goods and materials in process	83.9	72.8
Prepaid expenses	17.0	20.7
Total current assets	431.1	382.0
Plant and equipment:		
Land	19.4	17.3
Buildings	200.0	180.7
Machinery and equipment	448.4	407.6
Construction in progress	57.1	39.2
	724.9	644.8
Less accumulated depreciation	250.9	222.7
Total plant and equipment	474.0	422.1
Intangible assets	29.1	29.4
Other assets	7.7	5.5
Total assets	$941.9	$839.0
Liabilities		
Current liabilities:		
Accounts payable	$ 83.9	$ 58.9
Loans payable, including current maturities of long-term debt	25.7	27.4
Income taxes	40.2	34.6
Accrued liabilities	48.1	44.7
Total current liabilities	197.9	165.6
Long-term debt	84.0	80.3
Other liabilities	8.9	8.0
Deferred income taxes	53.9	40.5
Shareholders' equity:		
3½% cumulative preferred stock, $100 par value: Authorized and issued 66,763 shares less 62,986 shares in treasury (70.513 less 47,686 in 1977)	0.4	2.3
Common stock, $.50 par value: Authorized 100,000,000 shares (80,000,000 in 1977); issued 76,410,817 shares (76,389,877 in 1977)	38.2	38.2
Capital in excess of par value	32.2	31.0
Retained earnings	526.4	473.1
Total shareholders' equity	597.2	544.6
Total liabilities and shareholders' equity	$941.9	$839.0

exhibit 3 ***(continued)***

KELLOGG COMPANY AND SUBSIDIARIES
Consolidated Earnings and Retained Earnings
($ millions)

	December 31, 1978	*December 31, 1977*
Net sales:	$1,690.6	$1,533.4
Interest and other income, net	9.9	7.6
Total net sales, interest, and other income	1,700.5	1,541.0
Expenses:		
Cost of goods sold	1,093.5	988.0
Selling, general, and administrative expenses	324.3	281.2
Interest expense	9.7	9.2
Total expenses	1,427.5	1,278.4
Earnings before income taxes	273.0	262.6
Income taxes	127.9	124.4
Net earnings—$1.90 a common share ($1.81 in 1977)	145.1	138.2
Retained earnings, beginning of year	473.1	420.8
Dividends declared:		
Preferred stock—$3.50 a share	(.1)	(.1)
Common stock—$1.20 a share ($1.125 in 1977)	(91.7)	(85.8)
Retained earnings, end of year	$ 526.4	$ 473.1

KELLOGG COMPANY AND SUBSIDIARIES
Changes in Consolidated Financial Position
For the Years 1977 and 1978
($ millions)

	December 31, 1978	*December 31, 1977*
Financial resources were provided by:		
Net earnings	$145.1	$138.2
Depreciation	36.3	31.9
Deferred income taxes and other changes	14.5	10.1
Working capital provided by operations	$195.9	180.2
Increase in long-term debt	6.1	
Issue of common stock	.4	2.7
Sales of properties and other net changes	3.7	5.4
	206.1	188.3
Financial resources were used for:		
Businesses purchased, net of working capital acquired	2.0	14.0
Additions to properties, net of trade-ins	86.7	75.9
Capitalization of leases	6.4	
Cash dividends	91.8	85.9
Reduction in long-term debt	2.4	8.7
	189.3	184.5
Increase in working capital	$ 16.8	$ 3.8

exhibit 3 ***(concluded)***

	December 31, 1978	December 31, 1977
Analysis of increase (decrease) in working capital:		
Cash	$ 18.8	$ (38.9)
Marketable securities	3.6	2.4
Accounts receivable	7.1	24.6
Inventories	23.3	22.5
Prepaid expenses	(3.7)	6.7
Accounts payable	(25.0)	(4.3)
Loans payable	1.7	(10.4)
Income taxes	(5.6)	0.8
Accrued liabilities	(3.4)	0.4
Increase in working capital	$ 16.8	$ 3.8

KELLOGG COMPANY AND SUBSIDIARIES
Five-Year Financial Review
($ millions, except per-share figures)

	1978	1977	1976	1975	1974
Summary of operations:					
Net sales	$1,690.6	$1,533.4	$1,385.4	$1,345.0	$1,130.2
percent increase	10%	11%	3%	19%	22%
Cost of goods sold	1,093.5	988.0	890.6	898.2	795.4
Interest expense	9.7	9.2	9.0	6.3	5.5
Earnings before income taxes	273.0	262.6	252.2	212.7	143.5
Income taxes	127.9	124.4	121.8	104.9	69.4
Net earnings	145.1	138.2	130.4	107.8	74.1
percent increase	5%	6%	21%	45%	10%
Per common share:					
Net earnings	1.90	1.81	1.71	1.42	.97
Cash dividends	1.20	1.13	1.00	.73	.59
Average common shares (000)	76,404	76,311	76,127	76,068	75,966
Financial position:					
Current assets	431.1	382.0	364.7	386.6	264.2
Current liabilities	197.9	165.6	152.1	167.3	127.0
Working capital	233.2	216.4	212.6	219.3	137.2
Current ratio	2.2:1	2.3:1	2.4:1	2.3:1	2.1:1
Plant and equipment (net)	474.0	422.1	377.0	316.9	269.5
Total assets	941.9	839.0	765.5	726.1	555.0
Long-term debt	84.0	80.3	85.9	91.7	20.5
Common shareholders' equity	596.8	542.3	487.2	430.1	375.6
Other statistics:					
Capital expenditures	86.7	75.9	90.0	72.1	60.3
Depreciation	36.3	31.9	25.3	22.5	20.0
Cash dividends:					
On 3½% preferred stock	0.1	0.1	0.1	0.1	0.1
On common stock	91.7	85.8	75.3	53.9	43.8
Increase in retained earnings	53.3	52.3	54.9	53.8	30.3
Number of shareholders	20,869	20,351	20,054	19,940	19,889
Average number of employees	20,905	20,405	19.720	19,487	19,139

Source: Kellogg Company, annual report, 1978, pp. 21-29.

sticks, infant cereals, frozen pizza, coffee, desserts, and rolled oats. In 1978, Kellogg acquired facilities in England for processing and distributing both frozen foods and ice cream. Also, this same year a new frozen foods plant in Australia and a second cereal plant in Great Britain went into production. Foreign countries in which Kellogg operates are shown in Exhibit 4.[9]

The annual stockholders meeting

18 The Kellogg Company's annual meeting of shareholders is usually brief and tranquil. At the April 20, 1979 annual meeting, a group of dissident shareholders challenged Kellogg top management on the issue of promoting presweetened cereals to children. A resolution to restrict the advertising of presweetened cereals to children was brought by Sisters Carol Thresher and

exhibit 4
Foreign operations of Kellogg Company, 1978

Subsidiary	*Country*
Kellogg Salada Canada, Inc.	Canada
Farmhouse, Inc.[1]	
Kellogg Company of Great Britain, Ltd.	England
Askey's Ltd.[2]	
Favorite Food Products, Ltd.	
Cereal Packaging, Ltd.	
S. Reece & Sons, Ltd.	
P. H. Foods, Ltd.	
Kellogg (Australia) Proprietary, Ltd.	Australia
London Enterprises Pty., Ltd.[3]	
Kellogg Company of South Africa (Proprietary), Ltd.	South Africa
Kellogg de Mexico, S.A. de C.V.	Mexico
Kellogg de Colombia, S.A.	Colombia
Alimentos Kellogg, S.A.	Venezuela
Kellogg (Deutschland), GmbH	West Germany
Kellogg (Japan) K.K.	Japan
Nordisk Kellogg's A/S	Denmark
Caribbean Foods, Ltd.[4]	Jamaica
Kellogg's Products Alimentaries, S.A.	France
Kellogg Company Argentina S.A.C.I.F.	Argentina
Produtos Alimenticios Kellogg's, Ltd.	Brazil
Kellogg's Food Products, S.A.	Belgium
Kellogg de Centro America, S.A.	Guatemala
Salada Foods Jamaica, Ltd.[5]	Jamaica
Kellogg-Figueras Espana, S.A.	Spain

Source: Kellogg Company, form 10-K, annual report, 1978, p. 7.

Note: All subsidiaries shown above are 100 percent owned by Kellogg Company, except those followed by a footnote. Footnote explanations are as follows:
1. 100 percent owned by Kellogg Salada Canada, Inc.
2. All firms shown in this grouping are 100 percent owned by Kellogg Company of Great Britain, Ltd.
3. 66.7 percent owned by Kellogg (Australia) Proprietary, Ltd.
4. 75 percent owned by Kellogg Company.
5. 48.4 percent owned by Kellogg Company.

[9] Information for this section was drawn from Moody's Investors Service, Inc., *Moody's Industrial Manual,* 1979, p. 2521; and Kellogg Company, form 10-K, annual report, 1978, p. 2.

Clarice Steinfeldt of the Divide Savior Order, Milwaukee, Wisconsin.[10] This order participates in the Interfaith Center on Corporate Responsibility. The resolution was set forth in the company proxy statement and read as follows:

> Whereas, Kenneth Mason, president and chief operating officer, Quaker Oats, has said: "Quaker is in complete agreement that the time has come to make whatever changes in current television programming and advertising practices are necessary to make the children's television medium in the United States one in which all elements of our society can take pride";
>
> Whereas it is evident that the advertising to children of sugared cereals, candy, and other sweet products clearly promotes the purchase of those products and their consumption by children;
>
> Whereas the Council on Dental Health of the American Dental Association has endorsed "the elimination of advertising of sugar-rich products on children's television";
>
> Whereas, the American Academy of Pediatrics will encourage its 15,000 members to ask parents not to let their children watch programs that have advertising aimed at youngsters;
>
> Whereas the Federal Trade Commission, responding to petitions from two consumer advocate organizations—Action for Children's Television and Center for Science in the Public Interest—has initiated rulemaking procedures on children and food advertising;
>
> Whereas the Federal Communication Commission has reopened its children's television inquiry and will study the possibility of restricting advertising on all programs with sizable child audiences and eliminating advertising on children's television;
>
> Therefore be it resolved that the shareholders request the board of directors to establish as corporate policy that:
>
> 1. No televised advertising for any product will be directed to audiences primarily composed of children 8 or younger.
> 2. No televised advertising for highly sugared food products (whose consumption poses the most serious dental risks) will be directed to audiences primarily composed of children under 12.
> 3. Televised advertising for sugared food products not prohibited by (2), carried on programs where at least half of the audience is 12 or younger, shall be balanced by nutritional and/or health disclosures.[11]

19 The dissident shareholders submitted the following statement in support of their proposal:

> Since its beginnings, the use and misuse of television has been a concern of industry, government, and general public alike.
>
> Industry has responded to these concerns by developing a television code, in effect since 1952 and subscribed to by members of the National Association of Broadcasters. The public trust concept stressed in the code

[10] Amanda Bennett, "Kellogg Inc. Holders Defeat Curb on Ads Aimed at Children," *The Wall Street Journal,* April 23, 1979, p. 14.

[11] "Notice of Annual Meeting of Stockholders to be Held April 20, 1979," Kellogg Company, March 21, 1979, proxy statement, p. 10.

says that while television broadcasters are responsible for programming and advertising on their stations, the advertisers also have a responsibility to the viewing audience. Advertising directed to children, at first addressed as a part of the general guidelines, has been expanded into the "Children's Advertising Package."

The Council of Better Business Bureaus established a Children's Advertising Review Unit to "help ensure that advertising directed to children is truthful, accurate, and fair to children's perceptions."

We believe that a precedent of self-regulation has been set by industry and that the adoption of a policy on the advertising of products which contain significant amounts/percentages of sugar to children would establish our company as a leader of industry. If the regulations proposed by the FTC take effect, our company will already have conformed to the spirit of such regulations.[12]

20 The Kellogg Company board of directors recommended shareholders vote against this proposal and submitted the following statement in support of its recommendations:

> The company is vigorously opposing the adoption by the Federal Trade Comission of a trade regulation rule which would amount to essentially the same restrictions on advertising as are in the proposal. The Quaker Oats Company and the National Association of Broadcasters, mentioned by the proponents as being in favor of restriction, are also vigorously opposing the rule. The company adheres strictly to its policy of advertising its ready-to-eat cereals and other food products in ways which it believes will improve nutrition habits in the United States. Our advertised products provide excellent nutrition. Failure to eat an adequate breakfast is a widely prevailing nutrition deficiency in the United States.
>
> The company's advertising is directed toward improving breakfast habits. To the extent that children are encouraged to eat a better breakfast, our advertising works to improve nutrition of children. The company's advertising of foods usually eaten at breakfast shows a complete breakfast for the purpose of encouraging people generally, and children in particular, to eat a better breakfast.
>
> The company believes that the restrictions proposed by the staff of the Federal Trade Commission and the proponents of this proposal will reduce the company's ability to communicate with children who are important consumers of the company's product and may result in a deterioration in breakfast habits in the United States.
>
> The board of directors favors a vote *against* this proposal and proxies solicited by the management of the company will be so voted unless stockholders specify in their proxies a contrary choice.
>
> The affirmative vote of a majority of the shares of common stock present or represented at the annual meeting is required for approval of the proposal.[13]

[12] Ibid., pp. 10, 11.
[13] Ibid., p. 11.

21 In their letter of transmittal accompanying the proxy statement, J. E. Lonning, chairman of the board, and W. E. La Mothe, president and chief executive officer, stated the following regarding this proposal:

> The company is vigorously opposing adoption of this rule in the form of a federal regulation. Our television commercials are accurate and honest and we believe they have the effect of improving nutritional habits. It is important to the success of our business that we be able to communicate with our consumers.[14]

22 Discussion on the issue reportedly turned the annual meeting into a marathon. It was the first time in memory that there was a contested resolution at Kellogg and apparently was the first time a resolution on this matter had been presented directly to a cereal manufacturer.[15]

23 The company received 68,881,335 shares on the proposal. Of these, 66,747,934 were voted against and 1,342,539 were voted for the proposal.[16] Thus, 98 percent ofsthe Kellogg shares received were voted against this resolution.

Sugar consumption in the United States

24 During the past decade, many nutritionists, physicians, scientists, and others have voiced increasing concern over the amount of sugar and sweeteners now being consumed in the United States. Consider the following:

Every American now consumes an average of 130 pounds of sugar and sweetners each year.[17]

Per capita consumption of corn sweetner and other caloric sweetners has risen from 13.6 pounds per year in 1960 to 39.1 pounds per year in 1979.[18]

Per capita consumption of sugar, corn sweetner, and other caloric sweetners has increased 16.7 percent since 1960, from 111.2 pounds per year to 129.8 pounds per year in 1979.[19]

Americans now get about 24 percent of their total calories from sugar. Only 3 percent of this comes from fruits and vegetables. Another 3 percent is from lactose, the milk sugar in dairy products. The vast

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[14] J. E. Lonning and W. E. La Mothe, Kellogg Company letter to stockholders, March 21, 1979.

[15] Bennett, "Kellogg Inc. Holders," p. 14.

[16] Kellogg Company, *First Quarter Interim Report,* March 31, 1979, p. 1.

[17] U.S. Department of Agriculture, *Sugar and Sweetner Report,* December 1979, p. 35.

[18] U.S. Department of Agriculture, *Sugar and Sweetner Report,* December 1976, p. 27; and December 1979, p. 35.

[19] Ibid.

bulk that remains, 18 percent of total calories consumed, comes from sugar that is added to our food.[20]

In 1930, 64 percent of the sugar used in this country was purchased directly by consumers for home use, while only 30 percent went to industry. By 1970, only 24 percent of the sugar sold was purchased by consumers directly and 64 percent was used by industry. (The remainder went to restaurants, hotels, and government.) Today, sugar is the leading food additive in the United States.[21]

Certain foods contain very high proportions of sugar. In some cases, the consumer may not be aware of these high concentrations. For example, consider the following food items and the proportion sugar is of the total ingredients found in each: Jello (82.6 percent); Kellogg's Apple Jacks (55.5 percent); Hershey milk chocolate bars (51.4 percent), Sara Lee chocolate cake (35.9 percent); Wish Bone Russian salad dressing (30.2 percent); Heinz tomato ketchup (28.9 percent); Sealtest chocolate ice cream (21.4 percent); and Skippy peanut butter (9.2 percent).[22] For other foods and cereals, see Exhibits 5 and 6.

exhibit 5
Percentage of sugar contained in 24 common foods

Item	*Percent sugar*
Ragu spaghetti sauce	6.2%
Wish Bone Italian Dressing	7.3
Coca-Cola	8.8
Skippy Peanut Butter	9.2
Del Monte Whole Kernal Corn	10.7
Ritz Crackers	11.8
Dannon Blueberry Lowfat Yogurt	13.7
Shake'n Bake Seasoned Coating—Italian	14.7
Wyler's Beef Flavor Bouillon Cubes	14.8
Shake'n Bake Seasoned Coating—Original	17.4
Libby's Peaches (halves)	17.9
Birds-Eye Cool Whip	21.0
Sealtest chocolate ice cream	21.4
Hamburger Helper	23.0
Wish Bone Sweet'n Spicy French dressing	23.0
Quaker 100% Natural cereal	23.9
Heinz tomato ketchup	28.9
Wish Bone Russian dressing	30.2
Sara Lee chocolate cake	35.9
Shake'n Bake Seasoned Coating—Barbeque	50.9
Hershey's Milk Chocolate	51.4
Borden's Cremora	56.9
Coffee-Mate	65.4
Jell-O	82.6

Source: *Consumer Reports,* March 1978, pp. 137–39.

[20] "Too Much Sugar?" *Consumer Reports,* March 1978, pp. 136–37.
[21] Ibid., p. 137.
[22] Ibid., pp. 137–39.

exhibit 6
Sugar content of commerical cereal products

Product	*Percent sucrose content*	*Percent glucose content*
Shredded Wheat (large)	1.0	0.2
Shredded Wheat (spoon)	1.3	0.3
Cheerios	2.2	0.5
Puffed Rice	2.4	0.4
Uncle Sam Cereal	2.4	1.2
Wheat Chex	2.6	0.9
Grape Nut Flakes	3.3	0.6
Puffed Wheat	3.5	0.7
Alpen	4.1	1.7
Post Toasties	4.1	1.7
Product 19	4.1	1.7
Corn Total	4.4	1.4
Special K	4.4	6.4
Corn Flakes (Kroger)	5.1	1.5
Peanut Butter	5.2	1.1
Grape Nuts	6.6	1.1
Crispy Rice	7.3	1.5
Corn Chex	7.5	0.9
Corn Flakes (Kellogg)	7.8	6.4
Total	8.1	1.3
Rice Chex	8.5	1.8
Crisp Rice	8.8	.21
Concentrate	9.9	2.4
Rice Krispies (Kellogg)	10.0	2.9
Raisin Bran (Kellogg)	10.6	14.1
Buck Wheat	13.5	1.5
Granola (dates)	14.5	3.2
Granola (raisin)	14.5	3.8
Sugar Frosted Corn Flakes	15.6	1.8
40% Bran Flakes (Post)	15.8	3.0
Team	15.9	1.1
Brown Sugar–Cinnamon Frosted Mini-wheats	16.0	0.3
40% Bran Flakes (Kellogg)	16.2	2.1
Granola	16.6	0.6
100% Bran	18.4	0.8
All Bran	20.0	1.6
Granola (almonds)	21.4	1.2
Fortified Oat Flakes	22.2	1.2
Heartland	23.1	3.2
Super Sugar Chex	24.5	0.8
Sugar Frosted Flakes	29.0	1.8
Bran Buds	30.2	2.1
Sugar Sparkled Corn Flakes	32.2	1.8
Frosted Mini-Wheats	33.6	0.4
Sugar Pops	37.8	2.9
Alpha Bits	40.3	0.6
Sir Grapefellow	40.7	3.1
Super Sugar Crisp	40.7	4.5
Cocoa Puffs	43.0	3.5
Cap'n Crunch	43.8	0.8
Crunch Berries	43.4	1.0
Kaboom	43.8	3.0
Frankenberry	44.0	2.6

exhibit 6 ***(concluded)***

Product	*Percent sucrose content*	*Percent glucose content*
Frosted Flakes	44.0	2.9
Count Chocula	44.2	3.7
Orange Quangaroos	44.7	0.6
Quisp	44.9	0.6
Boo Berry	45.7	2.8
Vanilly Crunch	45.8	2.8
Baron von Redberry	45.8	1.5
Cocoa Krispies	45.9	0.8
Trix	46.6	4.1
Froot Loops	47.4	0.5
Honeycomb	48.8	2.8
Pink Panther	49.2	1.3
Cinnamon Crunch	50.3	3.2
Lucky Charms	50.4	7.6
Cocoa Pebbles	53.5	0.6
Apple Jacks	55.0	0.5
Fruity Pebbles	55.1	1.1
King Vitamin	58.5	3.1
Sugar Smacks	61.3	2.4
Super Orange Crisp	68.0	2.8
Mean	25.1	2.3

Note: Sucrose (table sugar) is composed of glucose and fructose. It is considered an important fuel for the bacteria that cause tooth decay. Glucose occurs naturally in many foods. It is about one half as sweet as sucrose and is considered less dangerous in causing tooth decay.

Source: Dr. Ira L. Shannon, U.S. Veterans Administration, *Business & Society Review*, Summer 1978, p. 27.

25 Dr. Jean Mayer, professor of nutrition at Harvard University during 1950–1976 and now president of Tufts University, has voiced strong concern over the level of sugar consumption in this country and its effect upon our health. He states:

> most practicing nutritionists, particularly those who work with children and the poor, consider sugar a menace to good nutrition. After reviewing the evidence, I believe it is adequate to show that the habitual consumption of large amounts of sugar is highly undesirable from the viewpoint of health and that sugar consumption should be reduced.[23]

26 Dr. Mayer characterizes our diet as one which, with slight variations, scientists consider typical of industrialized, urbanized countries. It is high in sugar, fat, salt, and processed foods. Between 20 and 25 percent of our calories come from sugar, as noted previously. Fat provides another 43 percent of our total calories. Salt intake is 10 times what the body requires daily. Above 50 percent of our total intake is in the form of processed foods.

[23] Jean Mayer, "The Bitter Truth about Sugar," *New York Times Magazine*, June 20, 1976, p. 26.

We are low in the consumption of fresh fruits and vegetables, whole grains, cereals, and the dried legumes that taken together provide 80 percent of calories one finds in the diet of many nonindustrialized nations.

27 He notes that while we have conquered the traditional infectious diseases and nutritional deficiencies, we are now falling prey to atherosclerotic diseases of the heart and blood vessels, cancer, diabetes, hypertension, obesity, and dental caries. Mayer believes that diet and lifestyle are involved:

> Nutrition research in the last three decades has yielded convincing evidence that the mere provision of enough calories, protein, and other essential nutrients—including generous amounts of vitamins and minerals—while sufficient to ensure growth and to avoid the classical nutritional diseases, is not an adequate prescription for long-term avoidance of the heart and blood vessels and other major premature killers of industrialized populations. We also know that total lifestyle, particularly in the matter of physical activity, and the effects of diet are interrelated; not only are excessive caloric intakes undesirable but where the calories come from is important.[24]

28 Regarding sugar, one major question is whether it is nutritionally equivalent to other carbohydrates that in the past provided the bulk of our calories. Today, over 50 percent of our carbohydrate intake is provided by sugar. Moreover, there has been a 25 percent decrease in overall consumption of carbohydrates in this country. This is due mainly to decreased use of flour (especially bread), cereal products, and potatoes.[25]

29 Dr. Mayer's concern with sugar is that it may not provide the nutritional value of other carbohydrates. Unlike the rest of our foods, sucrose (cane and beet sugar) is essentially a pure chemical. When digested, sucrose is broken down in one step in the intestine into glucose and fructose. Both of these are quickly absorbed into the bloodstream from the small intestine. The fructose is metabolized into glucose by the liver.

30 Glucose (blood sugar) is a primary fuel of the body. All carbohydrates are ultimately changed into glucose by digestion and metabolic processes. The issue is that other carbohydrates are components of complex foods. Lactose in milk, fructose in fruits, and large molecules of starches in wheat, corn, rice, other cereals, potatoes, and legumes are examples. The digestive process is slower for these complex foods than sugar, and this difference may be significant. For example, starches are converted to glucose in a series of steps in which intermdiate products, dextrins, and maltose are produced. These are then separated into individual glucose molecules. There is much debate on whether the various carbohydrates do differ in their effects on health.

31 Dr. Mayer believes that the high proportion of total carbohydrate intake now being supplied by sugar is not beneficial to health. The calories provided by sugar are not accompanied by nutrients. Moreover, these calories

[24] Ibid.
[25] Ibid., p. 29.

increase the need for certain vitamins and possibly the mineral chromium, which are needed to metabolize carbohydrates. Consequently, a greater burden is placed on the rest of the diet to provide all the necessary nutrients.[26]

32 A second major concern is the relationship between sugar consumption and dental caries. The primary cause of tooth decay and periodontal (gum and bone) disease is the inability to remove plaque from the teeth and gums. Plaque is formed by bacteria of various types normally found in the mouth interacting with food, principally sugar (sucrose). The bacteria ferment sugar to form acid. This acid can eventually dissolve tooth enamel and as a result accelerate tooth decay.[27]

33 Furthermore, sucrose is more likely to be a factor in dental disease than other carbohydrates because it is more easily fermented by the bacteria in the mouth.[28] Sticky forms of sugar such as those found in a caramel, hard candies, and some cookies are particularly troublesome, since they adhere to the teeth and are retained in the mouth for long periods of time.

34 Dr. Mayer cites the example of Tristan de Cunha, a remote island that until the 1930s was virutally free from commerce with the rest of the world. Its inhabitants existed on home-grown produce and fish. They did not consume any sugar. In 1932, a group of British physicians and scientists examined the islanders and found them to be practically free of dental caries. During the next 30 years these people were in frequent contact with the outside world, became habituated to a high level of sugar consumption, and developed what Mayer termed "a catastrophic prevalence of tooth decay."[29]

35 Dr. Mayer also cites a study of the U.S. government in the 1960s in which the results of more than 100 international surveys of the prevalence of tooth decay in different populations were analyzed. With the exception of fluoride content of the water supply, the only consistent relationship between nutrition and tooth decay was sugar consumption. In the Far East, in countries where sugar consumption averaged 12 to 32 pounds per person per year at that time, the national averages for decayed, missing, or filled teeth ran from 0.9 to 5 per person in adults 20 to 24 years ol. In South American countries, where sugar intake averaged 44 to 88 pounds per person each year, the averages for decayed, missing, or filled teeth in the same age group ranged from 8.4 to 12.6. With respect to the United States today, it is estimated that 98 percent of American children have some tooth decay and that by age 65

[26] Ibid., pp. 26 and 29.

[27] Comment of Dr. Marvin Mansky, president of New York state chapter of the American Society for Preventative Dentistry, in "Sugar: Can It Be a Health Hazard?" *Good Housekeeping,* August 1973, p. 13.

[28] Comment of Dr. James H. Shaw, professor of nutrition at the Harvard School of Dental Medicine, Ibid.

[29] Mayer, "Bitter Truth, p. 29.

about one half of the population has no teeth.[30] Dr. Mayer asserts that "sugar is certainly associated with the most widespread degenerative disease in the Western world—dental caries."[31]

36 A third major area of concern surrounding the consumption of sugar is its contribution to obesity. Excessive weight is a serious health problem in the United States today. It can be shown that 10 to 20 percent of all U.S. children are overweight. Moreover, 35 to 50 percent of all middle-aged Americans are overweight.[32] An analysis of data on food consumption and the heights and weights of the population shows that since 1900 we have grown taller but we have grown heavier and fatter even faster. While there has been a gradual diminution in total food intake, our level of physical activity has dropped much faster than our caloric intake.

37 Again, Dr. Mayer holds that our increased sugar consumption must be viewed in this context. Assuming 4 calories per gram, the 130 pounds of sugar each American consumes annually provides more than 511 calories per day. This is the energy equivalent of more than 53 pounds of fat each year. Dr. Mayer comments that people with a weight problem certainly do not need sugar. He further indicates that in every instance in which sugar has been introduced into a food, the nutrient density of that food drops. He believes that at a time when we need to reduce our food intake to reduce excessive weight, "we cannot afford the size of this otherwise useless caloric contribution."[33]

38 Moreover, the concern over obesity is not merely one of cosmetic effect. There are serious medical conditions and diseases often associated with excessive weight. These include hypertension, high blood cholesterol, and diabetes. With respect to diabetes, between 5 and 12 million Americans are classified as diabetic, depending upon the cut-off point for blood-glucose level chosen in the definition. About 1,000 new cases per day were being reported in 1976.[34] Dr. Mayer reports there is strong suspicion that a large sugar intake may be causally related to diabetes, both indirectly by promoting obesity and directly as a source of repeated stress on the insulin-producing mechanism of the body:

> A large sugar intake means that huge amounts of rapidly digested and absorbed simple sugars (glucose and fructose) flood the body at intervals. The sudden glucose influx, in particular, may represent a stress with which the insulin-secreting islets of the pancreas of individuals genetically prone to diabetes cannot cope. After a period of hyperactivity, the cells which produce insulin gradually exhaust themselves. Other endocrines such as the adrenals may be additionally affected. A number of studies in populations,

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[30] Ibid., p. 31.
[31] Ibid., p. 29.
[32] Ibid., p. 31.
[33] Ibid.
[34] Ibid.

though not totally conclusive, seem to support the view that a large sugar intake promotes diabetes.[35]

39 Dr. John Yudkin, physician, biochemist, and emeritus professor of nutrition at the University of London presents one of the more unorthodox and challenging theories about excessive sugar consumption. Dr. Yudkin's research points to sugar as an important factor in heart disease. Too much sugar, not animal fat, may be the chief cause of coronary thrombosis because it may stimulate the body to manufacture too much cholesterol.

40 In one study of coronary death rates in 15 countries, Dr. Yudkin found that death rates increased steadily as sugar consumption increased. For countries in which per capita consumption of sugar is 20 pounds per year, the coronary death rate was 60 deaths per 100,000 people. As annual sugar consumption increased to 120 pounds per person, the death rate rose to 300 deaths per 100,000 people. At a consumption rate of 150 pounds per year, the death rate rose to 750 per 100,000.[36]

41 Dr. Yudkin notes other evidence in support of his hypothesis. For example, the Masi tribes of East Africa live primarily on meat and milk, consuming practically no sugar. There is little heart disease among these people. In contrast, on the island of St. Helena in the South Atlantic, sugar consumption averages 100 pounds per person per year. The incidence of heart disease is high among these people.[37]

42 Dr. Yudkin also points out that while sugar is an important cause of heart disease, it is not the only cause. Sedentariness and smoking are important factors, and both have increased in the past 50 years. Genetic and environmental factors must also be considered. Nonetheless, Dr. Yudkin states unequivocally, "If only a fraction of what is already known about the effects of sugar were to be revealed in relation to any other material used as a food additive, that material would be promptly banned."[38]

43 Another authority voicing concern about the high level of sugar consumption in our diet is Dr. Leo Screebny, dean of the School of Dentistry, State University of New York at Stonybrook: "If cigarettes carry warnings about lung cancer, then clearly sugar should carry warnings about this public health problem."[39]

44 In 1978, *Business & Society Review* asked a group of individuals vitally interested in this issue to respond to Dr. Screebny's remarks. The questions asked were (1) Is the eating of refined sugar a public health problem? and (2) What, if anything, should be done about it? The responses of some of

[35] Ibid.
[36] Andrew Hamilton, "Some Sour Facts about Sugar," *Science Digest,* July 1975, pp. 47–48.
[37] Ibid., p. 48.
[38] Ibid.
[39] "Is Sugar a Menace to Health?" *Business & Society Review, Summer 1978, p. 21.*

these individuals are presented below, either in excerpted form or in their entirety.

45 Dr. Donald H. Masters, president of the American Society for Preventative Dentistry, commented about the negative aspects of sugar consumption and the lobbying power of the food processing industry:

> There is no question that sugar is a health negative, and if it were reexamined with the same criteria as any other drug that has crept into the food chain, it would certainly not pass. Even FDA biochemists have substantiated this.
>
> As to what to do about it, this still remains a very vexing problem. Most nutritional information comes from food processing companies themselves. The food processing industry is backed up by a tremendously lucrative lobby, and chances of congressional action are certainly minimal. At least people should be made aware of the dangers of sugar in foods and then could at least make an intelligent choice. This would require a considerable campaign with attendant expenses and would be fought vigorously by the food industry. We've studied the approach to national public awareness and can only hope that the "uncontrolled media" would assist in this regard. However, the uncontrolled media is becoming harder and harder to find.[40]

46 Dr. Derrick B. Jellife, at the UCLA School of Public Health stated: "Most certainly, the question of 'sugar abuse' is a highly important public health issue. It is related not ónly to the prevalence of dental caries, but also to obesity and very possibly to other important maladies as well, including, for example, diabetes, and even heart disease."[41]

47 Dr. Ira L. Shannon, director of the Oral Disease Research Laboratory at the Veterans Administration Hospital in Houston, Texas, believes the frequency of sugar ingestion and the ubiquitous presence of sugar constitute a health hazard:

> *Business and Society Review* poses two specific questions concerning sugar. First, "Is the eating of refined sugar a public health problem?" From the point of view of dental decay, it is not just a problem, it is virutally *the* problem. The dental danger results primarily from the pattern of usage of sugar rather than from the actual amount ingested. It is true that clinical studies have been conducted that make clear that dental decay is not increased by adding sugar at mealtimes. If this were the entire story, as some commercial sugar people would have you believe, the problem would not be of such great consequence. The real problem is the frequency of ingestion of sugar. A sticky caramel that holds sugar in the mouth for a long period is more dangerous than a fast-clearing product. But in today's market many products not generally considered to contain sugar—cough syrups, chewable vitamins, breath drops, etc.—do indeed contain large amounts of this dentally hazardous product. It is truly the ubiquitous presence of sucrose

[40] Ibid., p. 22.
[41] "Is Sugar a Menace" p. 31.

> that is the problem. Couple this with very unsatisfactory labeling requirements, and the high level of dental decay can be easily explained.
>
> Secondly, "What, if anything, should be done about it?" The only satisfactory answer lies in patient education. This is possible only if manufacturers are required to list in clear and direct fashion exactly how much sugar has been added in the preparation of the product. The only way that we can beat the billions of dollars of advertising money behind the sugared products is to hope that certain of the manufacturers will begin to advertise that not all of that sugar is necessary and that it has been either dropped entirely or severely restricted in their product. I believe this is probably the only realistic hope that we have. The facts have been presented squarely to a Seante subcommittee and it is apparent that, even though its members appeared appalled, very little, if anything, has been done in the way of constructive course of action.[42]

48 Dr. John D. Brunzell, chairman of the Committee on Food and Nutrition of the American Diabetes Association, believes it is too early to arrive at a verdict on the sugar controversy:

> The American Diabetes Association is now attempting to draft a position statement on the use of various kinds of sugar in the diet of diabetics, but as yet has not decided on a unanimous opinion as to whether or not all sugars pose the same risk of various complications.
>
> The comment by Dr. Leo Screebny as it relates to refined sugar, or sucrose, certainly relates to the connection between eating sucrose and tooth decay. This statement also points out the need to define what we mean by sugar because some sugars, such as fruit sugar (fructose) and some sugar alcohols, are not associated with tooth decay. The question of whether sucrose sugar-eating causes obesity, diabetes, or heart disease, however, is open to much debate. It is these latter questions we are considering in the American Diabetes Association. . . .
>
> Except for the association with tooth decay, I believe it is too soon to put a public health warning on food containing sugar similar to that carried by cigarette packages at present.
>
> Because of the debate concerning the role of sucrose in public health problems, much research is going on at the present relating to the association of sucrose, diabetes, obesity, and atherosclerosis. Most of the data in humans to date would suggest that such associations do not occur.[43]

49 Speaking on behalf of sugar consumption is John B. Bunker, chairman of Holly Sugar Corporation:

> The eating of refined sugar is not a public health problem and never has been. Sugar (sucrose) is nothing but water, air, and sunshine (or crystallized sunlight, if you prefer). Sucrose, the sugar of household and industry, is the

[42] Ibid.
[43] Ibid., p. 25.

most common sugar in the plant kingdom and has been used routinely since antiquity.

Evidently, Dr. Screebny is unfamiliar with the Federation of American Societies for Experimental Biology's four-year study of sugar commissioned by the Food and Drug Administration. Its conclusion was that sugar at current levels of consumption is safe, although it did acknowledge its contribution as one factor in the multifactorial problem of dental decay. This means that sugar does not cause death-dealing or harmful diseases, that there is no substantiated scientific evidence indicating that sugar causes diabetes, heart disease, or any other malady. Neither does sugar cause obesity; overeating does.

Sugar as a carbohydrate in certian sticky forms contributes to dental caries. However, it isn't the amount of sugar that contributes to this problem but the form in which it is ingested. Good dental hygiene and fluoridation of domestic water supplies would go far toward eliminating dental caries and would be much more effective than warning labels.[44]

50 J. W. Tatem, Jr., president of the Sugar Association, Inc. strongly asserts that sugar is safe and nutritious:

I must state emphatically that scientific evidence shows sugar to be safe and not a threat to health. It is understandable that Dr. Screebny, a dentist, would be unaware of the large body of scientific evidence attesting to sugar's safety, apart from its role in dental caries. Permit us to cite some of this evidence.

As part of its continuing review of foods that are generally regarded as safe (GRAS), the Food and Drug Administration commissioned the Federation of American Societies for Experimental Biology to assess the health aspects of sucrose consumption. Accordingly, a select committee was appointed, and a review of the scientific literature on sucrose was undertaken. In addition, the committee held a public hearing for the purpose of airing any pertinent unpublished information.

After reviewing the available evidence this committee of highly qualified scientists concluded: "Other than the contribution made to dental caries, there is no clear evidence in the available information on sucrose that demonstrates a hazard to the public when used at the levels that are now current and in the manner now practiced." No specific evidence linking sugar to death-dealing diseases such as heart disease or diabetes was found. With regard to dental caries, the committee noted that sugar consumption is but one of many factors involved in this multifactorial disease.

The conclusions of this report stand as refutation to many of the popular myths regarding sugar and should be taken into account whenever the health aspects of sucrose consumption are discussed.

I should like to point out for emphasis that this report represents a summation of the scientific record regarding sugar. Many scientists working

[44] Ibid., p. 22.

independently in fields such as diabetes, obesity, heart disease, and dental caries have come to similar conclusions.

With regard to Dr. Screebny's specialty, dental caries, it should be acknowledged that sugar consumption is one factor involved in this disease. However, the relationship is not one to one, and those who propose that a reduction in sugar consumption would result in a reduced incidence of dental decay are misleading the public. In fact, there is no evidence to support such a conclusion.

The position of the dental community on this question was succinctly expressed in a recent statement by the president of the American Dental Association. Commenting on a proposal to reduce sugar consumption, Dr. Frank F. Shuler said: "Current accepted dental research will not support the conclusion that a reduction in the consumption of sugar will decrease the level of dental caries. Research studies have shown that the total amount of sugar ingested is only one of several factors contributing to dental decay. The frequency with which sugar-rich foods are ingested, the length of time they remain in the mouth, and the physical form of the food are equally important."

Another unscientific aspect of Dr. Screebny's remarks is his failure to consider the contributions sugar makes to a balanced diet. Sugar is a significant source of dietary carbohydrate, the body's primary energy source. Its physical and chemical properties make it extremely useful in the preparation of a wide variety of foods. Sugar, in moderation, adds to the pleasure of eating and contributes to a balanced diet by making all types of nutritious foods palatable.

It is unfortunate that unsubstantiated statements like Dr. Screebny's often receive more public attention than authoritative scientific pronouncements.[45]

51 The last of the respondents in the *Business & Society Review* survey to be considered here is Ogden C. Johnson, vice president of Hershey Foods. He argues that the real problem with the American diet is overeating:

Hershey Foods Corporation has had an interest in this area for many years and has been following very closely the proposed actions of professional societies, consumer activitists, and the government in relation to controls on advertising and labeling of sugar and sugar-containing foods.

A careful evaluation of the scientific literature reveals that the sugar content of the total diet is one of the factors associated with the development of dental caries. The literature does not support the view that health problems such as diabetes, heart disease, or obesity are specifically related to sugar consumption. Each of these is related to excess consumption of calories in any form which will result in obesity. There is not, in our opinion, evidence supporting the direct relationship between the consumption of sugar and these disease problems.

The problem of reducing sugar consumption has been considered by many individuals and groups. If one analyzes the American diet, it is appar-

[45] Ibid., pp. 24, 25.

> ent that sugar present in the ingredients and food commodities we consume, as well as sugar added such as in canned fruits for preservation and sweetness purposes, is an integral part of the total diet. The removal of one or two products or reduced consumption of a single class of products will have relatively little effect on total sugar consumption. Those foods and calories eliminated by reduction of sugar-containing foods will be replaced by other foods which will most likely contain sugars.
>
> The evidence we have reviewed does not indicate that the consumption of sugar, either refined or naturally present in foods, is a public health problem. If there is a problem associated with sugar, it is related to excess consumption of foods, some of which contain sugar, and the failure to practice good dental hygiene.[46]

52 To complete this review of sugar consumption in the United States, it is interesting to note the comments of Dr. Frederick J. Stare, chairman of the department of nutrition at the Harvard School of Public Health: "Sugar can play a useful role, in moderation, in a person's diet because it is the cheapest source of energy."[47]

53 In testimony before the consumer subcommittee of the Committee of Commerce, U.S. Senate, in 1970, Dr. Stare stated the following:

> Breakfast cereals are good foods. A breakfast of cereal and milk—any kind of cereal—along with some fruit, a couple of pieces of toast, some polyunsaturated margarine, a little jelly or jam, is just as nutritious as a bacon and egg breakfast with fruit, toast, and something to put on the toast.
>
> In fact, in my opinion it is a better breakfast for most of us, including children and grandchildren and grandparents, because the cereal breakfast has less saturated fat and cholesterol.[48]

54 In the same proceeding, Dr. Stare testified that adding sugar to cereal to get a child to eat it is not objectionable:

> Now, if a child does not like to eat breakfast, and yet he will eat a breakfast cereal because of a little sugar on it and he likes the sweet taste, I do not see anything wrong. You are doing more good; you are getting breakfast food to him. There is nothing wrong with sugar in nutrition, in moderation.[49]

Kellogg's position

55 In their study *Product Innovation in Food Processing,* Robert D. Buzzell and Robert E. M. Nourse report that the addition of sugar to cereal in 1949 was the prime reason for a turnaround of slumping sales of cereals during

[46] Ibid., pp. 25, 26.

[47] "Sugar: Can It Be a Health Hazard?" p. 13.

[48] Hearings before the consumer subcommittee of the Committee Commerce, U.S. Senate, 91st Congress, 2d sess. on dry cereals, July 23, August 4, and 5, 1970, p. 134.

[49] Ibid., p. 147.

that period.[50] Since that time, the varieties of presweetened cereals have increased dramatically. Kellogg began producing presweetened cereals in the mid-1950s and now 8 of the 22 cereal brands produced and marketed by the company are presweetened.[51] In general, all Kellogg presweetened cereals provide the same nutrients as the nonpresweetened cereals. (See Exhibit 7) In 1978, Kellogg cereal sales were $1,260 million out of total company sales of $1,690 million. Presweetened cereal sales accounted for 33 percent of total cereal sales that year and are promoted almost totally through television advertising to children.[52] Total company profits in 1978 were $145.1 million as mentioned previously, while profits on cereal sales amounted to $116 million.[53]

56 At the close of the 1979 annual meeting, William E. La Mothe, chief executive officer of Kellogg, indicated he was especially pleased with the response of shareholders to the resolution proposing a ban on television advertising of the company's products to children. As noted earlier, 98 percent of the shares voted were against this resolution. La Mothe stated the company would continue vigorously to oppose the Federal Trade Commission's suggested ban on advertising to children.

57 La Mothe continued by saying:

> A fundamental principle of Kellogg Company has been to produce ready-to-eat cereals of the highest quality, and to advertising our products in an honest and truthful manner. I believe that the real vote of confidence is cast by millions of American consumers every day who enjoy nutritious ready-to-eat cereal breakfasts.[54]

58 At this same meeting, Dr. Gary E. Costley, vice president, explained in detail the nutritional value of ready-to-eat cereals. He noted that research explicitly demonstrates that when children and adults consume regular or presweetened cereals as a part of a balanced breakfast, that breakfast is enhanced. It can be shown that cereal breakfasts provide more vitamins, more minerals, more fiber, the same amount of sugar, less calories, less protein, less cholesterol, and less fat than breakfasts which do not include ready-to-eat cereals. (An example of research findings discussed by Kellogg is set forth in Exhibit 8. Comments by Consumers Union are also included in this exhibit.)

59 Dr. Costley continued by noting that 95 percent of all ready-to-eat cereals are consumed with milk and that they are eaten primarily at meals, not as

[50] Robert D. Buzzell and Robert E. M. Nourse, *Product Innovation in Food Processing* (Boston, Mass.: Division of Research, Graduate School of Business Administration, Harvard University, 1967), p. 36. The development of especially high nutrient cereals beginning in 1955 with Kellogg's Special K was the other main contributor to increased sales.

[51] "Kellogg: Still the Cereal People," p. 82; and *Kelloggs: A Quality Story*, p. 4.

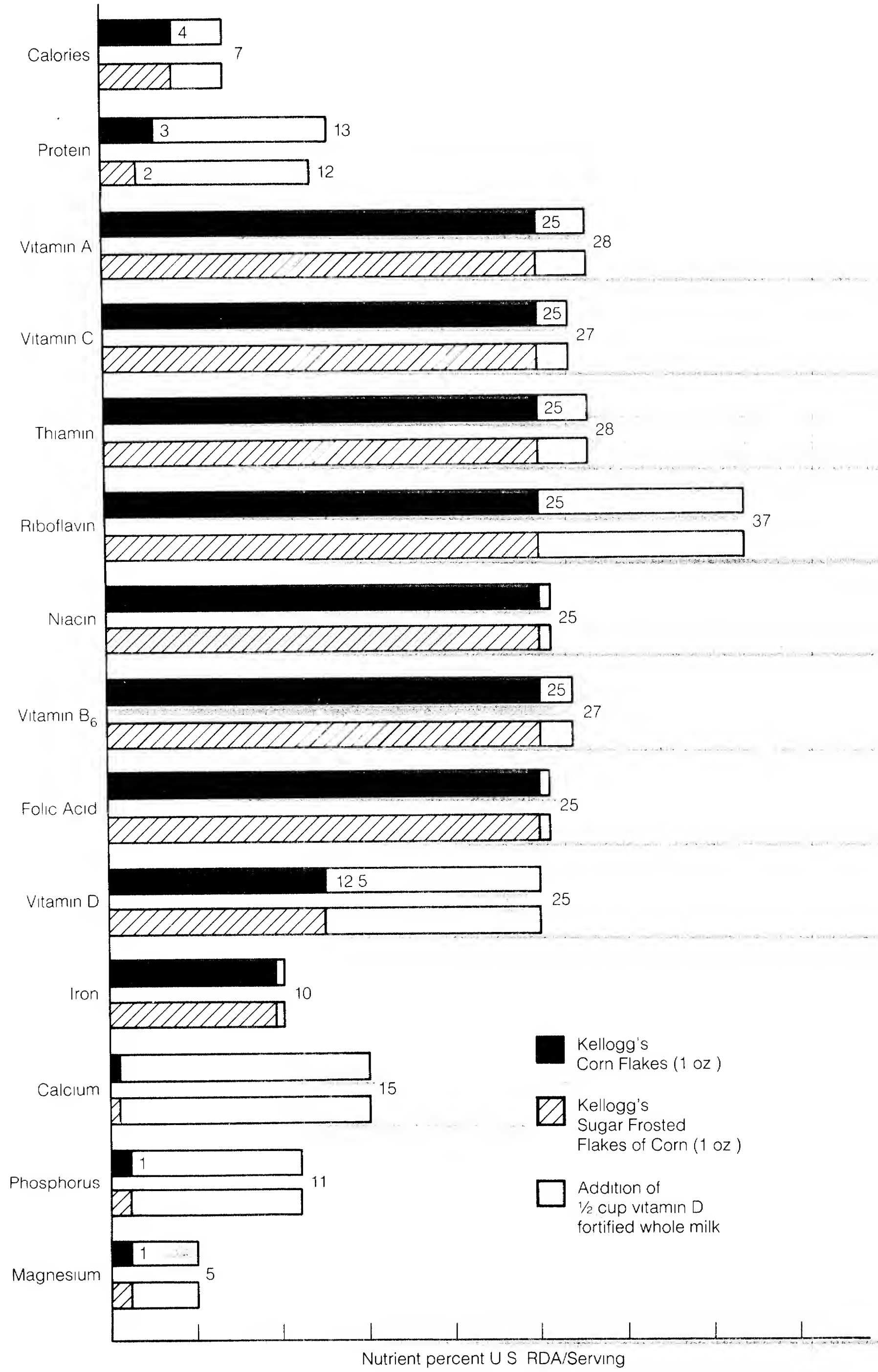
[52] "Kellogg: Still the Cereal People," p. 89.

[53] Ibid., p. 80.

[54] *First Quarter Interim Report*, p. 3.

exhibit 7

Nutrient profile of ready-to-eat cereals: Kelloggs Corn Flakes and Kelloggs Sugar Frosted Flakes of Corn, 1978



Source: The Kellogg Company.

exhibit 8
Kellogg Company research and statements on presweetened cereals with comment by Consumers Union

Sweet talk about sweetened cereals

Late last year, during an investigation of advertising aimed at children, the Federal Trade Commission took a particular interest in the promotion of highly sweetened cereals to youngsters. Kellogg Co. showed up to defend the nutritional quality of its products. At about the same time, Kellogg apparently decided to take its case to the public.

In mid-November, the two page ad shown above appeared in newspapers in Boston, Chicago, Detroit, Los Angeles, New York, and Washington, D.C. The body of the ad presented a list of bold-faced facts—or, more accurately, assertions. The assertions merit some comment.

Kellogg says: "Ready-sweetened cereals are highly nutritious foods."

Some cereals are highly nutritious, and some aren't. But the presence of sugar or other sweeteners adds nothing except calories to a cereal's nutritive value. When CU last tested cereals (see *Consumer Reports,* February 1975), Kellogg's presweetened Sugar Frosted Flakes, Sugar Smacks, Sugar Pops, and Cocoa Krispies were among those "judges of sufficiently low nutritional value to be considered deficient."

Kellogg says: "Ready-to-eat cereals do not increase tooth decay in children."

Kellogg points out that three clinical studies found no relationship between the amount of cereals consumed, whether ready-sweetened or regular, and the incidence of tooth decay in children.

Kellogg does not point out, however, that the authors of one of those studies stated that "this conlcusion must not be construed to dilute in any way the evidence associating dental caries with sucrose in general."

Essentially, it's not cereals that increase tooth decay, but the total aggregate of sugars in cereals, sweets, and numerous other processed foods. As Dr. W. H. Bowen of the National Caries Program at the National Institutes of Health commented: "There is now an overwhelming abundance of evidence from experiments carried out in animals (both rodents and primates), epidemiological studies in humans, and kindred other bodies of evidence that proves quite conclusively . . . that the development of caries and ingestion of sugar are closely associated."

Kellogg says: "Ready-to-eat cereal eaters skip breakfast less than nonready-to-eat cereal eaters."

The supporting text cites Kellogg's own analysis of an unpublished study. (The analysis involved only 250 children.)

It's probably churlish of us to point out that no comparison is made between eaters of ready-sweetened cereals and eaters of unsweetened cereals. The ad speaks only of "ready-to-eat" cereals and "nonready-to-eat" (or cooked) cereals. It's hard, therefore, to conclude that failure to *presweeten* a cereal will produce an epidemic of breakfast skipping.

Kellogg says: "There is no more sugar in a one-ounce serving of a ready-sweetened cereal than in an apple or banana or in a serving of orange juice."

Perhaps not. But Kellogg's presentation is comparing *one ounce* of cereal with servings of fruit that weight at least four times as much. To detect that thumb on the scales, a consumer would have to know that there are about 28 grams in an ounce, and that a medium apple or banana each weighs about 115 grams. Moreover, the percentage of sugar in food may play a role in tooth decay. With that in mind, let's compare the data Kellogg presented with a factor the ad didn't mention—the sugar's concentration:

exhibit 8 ***(continued)***

Food	*Mentioned total sugar content per serving (in grams)*	*Not mentioned sugar concentration (in percent)*
Kellogg's Sugar Frosted Flakes (1 oz.)	11 grams	39%
Kellogg's Apple Jacks (1 oz.)	16	57
Apple (1 med.)	17	11
Orange juice (6 oz.)	17	9
Banana (1 med.)	29	19

Kellogg says: "The sugars in cereals and the sugars in fruit are chemically very similar."

Supporting text notes that the principal sugars in cereals are sucrose and glucose, and that fruits contain those sugars plus fructose.

True, sucrose is sucrose and glucose glucose, whether in a cereal or in a fruit. But fruit sugars frequently include a relatively high percentage of fructose, which is somewhat less conducive to dental decay than sucrose.

Kellogg says: "Ready-to-eat cereals provide only 2 percent of the total consumption of cane and beet sugars in the United States."

But the use of sucrose in processed foods, including breakfast cereals, doubled between 1940 and the present. And among the uses of sugar Kellogg mentions (beverages, baked goods, confectionery, ice cream, and the like), breakfast cereals are perhaps the single category most directly promoted to young children.

Kellogg says: "On the average when children eat ready-sweetened cereals as part of a breakfast, the nutrient content of that breakfast is greater than when they eat a nonready-to-eat cereal breakfast."

Read that statement carefully, for it does not compare the nutritive contents of presweetened and unsweetened dry cereals, nor does it compare dry cereals (with or without sugar) with cooked cereals. Rather, the ad refers to the relative nutrient content of the *breakfasts* eaten by some 250 children in an unpublished study. Even so, Kellogg's nutrient chart shows that the cooked-cereal breakfast surpassed the other in protein content, as well as in phosphorus, magnesium, and zinc. Moreover, as CU's 1975 cereal study demonstrated, an important factor is the biological availability of nutrients. The nutrients that occur naturally in foods are apt to be used by humans to a greater extent than nutrients added to a food.

Kellogg says: "Most ready-to-eat cereals are consumed with milk."

Probably true—although we wonder how many parents have observed their children nibbling on dry, ready-sweetened cereals as a snack. As consumer reporter Sidney Margolius once observed, "If milk is the main nutritional value in eating dry cereals, then obviously there are easier ways to drink it than with a spoon." In any event, the statement tells us nothing about any differences between ready-sweetened and unsweetened cereals, since the subject is "ready-to-eat" cereals, not "ready-sweetened" cereals.

Kellogg says: "On the average when children eat ready-sweetened cereals as part of breakfast, consumption of fat and cholesterol is less than when they eat a nonready-to-eat cereal breakfast."

Again the data source is an unpublished study. And again, the statement by Kellogg makes no comparison between ready-sweetened and unsweetened ready-to-eat cereals (the comparison is between *breakfasts* that include either a cooked or

exhibit 8 ***(concluded)***

an uncooked cereal). Instead, it plays on dietary scare words such as *fat* and *cholesterol*, which have nothing to do with the cereals themselves.

> Kellogg says: "The per capita sugar consumption in the United States has remained practically unchanged for the last 50 years."

The graph that Kellogg presents with this statement shows, accurately enough, that per-capita consumption of cane and beet sugar (both sucrose) has held fairly steady at some 90 to 100 pounds per year since 1920.

But a closer look at the graph also shows that per-capita consumption of all sugars, including corn sugar, has increased nearly 30 percent since 1920. The graph doesn't show that much of the sugar we now eat is added to food before we buy it—and in amounts unknown to the buyer.

The ad is Kellogg's slippery way of responding to the chorus of complaints about television commercials peddling highly sugared foods to children. Last year, several public interest groups, including the Committee on Children's Television and the California Society of Dentistry for Children, sued another cereal-maker, General Foods Corp., over commercials for what they call "candy breakfasts" sold as part of the company's Post Cereals line.

The lawsuit charges that General Foods "exploits trusting children in order to sell sugar concoctions as nutritious breakfast cereals." It alleges that the company through the expenditure of approximately $1 billion in television advertising and marketing, has "induced the formation of lasting poor nutrition habits and tooth decay in millions of children, particularly youngsters from low-income families."

The suit, which asks General Foods to change its labeling and advertising and pay more than $1 billion in penalties, isn't the only problem manufacturers of sugared foods for children are facing. Two activist organizations, Action for Children's Television and Center for Science in the Public Interest, have separately petitioned the FTC to ban television commercials to children for candy and other sugary snack food. The center's petition was supported by more than 10,000 physicians, dentists, dieticians, nutritionists, and health students.

The FTC is currently considering a number of proposals to crack down on advertising aimed at children. The result could be an outright ban on commercials for highly sugared products on children's programs, or else strict guidelines for those commercials and perhaps a requirement that broadcasters set aside time for counter-commercials. Any such proposal, however, is expected to face years of hearings and court challenges from industry.

Source: *Consumer Reports,* March 1978, pp. 140–41. Reprinted with permission.

snacks as alleged by some critics. Dr. Costley stated that four clinical studies proved that presweetened cereals do not increase the amount of tooth decay among children.

60 Finally, Dr. Costley stated:

> It makes no sense for the Federal Trade Commission to propose a rulemaking proceeding which bans the advertising of wholesome nutritious foods like ready-to-eat cereals with no analysis as to the consequence of this ban. It is nutritional nonsense to argue that children will benefit in any way from a rule which bans the advertising of cereals since the data demonstrate that children derive substantial benefit from these products.[55]

[55] Ibid.

61 In a 1978 interview, La Mothe discussed the company's position on advertising to children. First, Kellogg tries to develop commercials that are entertaining and carry a message. Second, the firm is convinced that every young person in this country would have a better diet if he or she consumed a ready-to-eat cereal, rather than the mix of things with high cholesterol and high fat now consumed or no breakfast at all. La Mothe indicated: "We are almost evangelistic in our thrust to try to convince youngsters to be interested in breakfast."[56]

62 Commenting upon the desire of some consumerists to discourage the consumption of presweetened cereals, La Mothe commented: "What many of the consumers don't want to admit is that a medium-size apple has as much if not more than a serving of Sugar Frosted Flakes. They just can't get their mind around what sugar really is and the quantities we are really talking about."[57]

63 Lastly, Kellogg has supplied the Federal Trade Commission and consumer groups with data defending the nutritional value of its children's cereals and deemphasizing their sugar content. Kellogg's data show that the company's presweetened cereals account for only 3 percent of a child's daily sugar consumption. The company notes that, in comparison, soft drinks contain three times the amount of sugar per serving. Foods such as this are considered by Kellogg to be the real culprits.[58]

Kellogg in the 1980s

64 As Kellogg enters the 1980s, it faces several developments which bear upon the company's long-term success. First, the Federal Trade Commission recently completed hearings in San Francisco and Washington examining proposals to limit or ban advertising to children.[59] Hearings on disputed issues will follow. These proceedings stem from an FTC staff recommendation issued in May 1978, proposing that advertising of highly sugared foods directed at children under 12 years of age be banned or severely restricted. Underlying this proposal is a general concern over the health impact of high sugar consumption in this country. Also, the Federal Communications Commission is conducting an inquiry into advertising aimed at children and the Senate communications subcommittee has announced it will be studying the matter.

65 Second, the Federal Trade Commission antitrust case against Kellogg, General Mills, and General Foods continues.[60] Filed in 1972, this suit charges that these companies have a shared monopoly in which they rely on

[56] Rance Crain, "A Conversation with Kellogg's W. E. La Mothe," *Advertising Age*, October 2, 1978, p. 60.

[57] Ibid.

[58] "Kellogg: Still the Cereal People," p. 89.

[59] *Industry Surveys*, p. F31.

[60] Ibid. Quaker Oats was originally included as a defendant but was dismissed in January 1978.

exhibit 9
Glossary of terms

Fructose.	Natural sugar found in fruits.
Glucose.	Sugar that exists in our blood, derived from starches and other kinds of sugar we consume.
Lactose.	A natural sugar found in milk.
Maltose.	A natural sugar derived from malt.
Sucrose.	Ordinary refined table sugar (white or brown).

Source: *Science Digest*, July 1975, p. 44.

their financial strength to introduce so many new brands that they effectively prevent new companies from entering the business. This in turn encourages high prices and excessive profits for these three largest producers in the industry. The case is still in hearings before an administrative law judge. The Federal Trade Commission is attempting to split Kellogg's cereal operation into five pieces by forcing divestiture of four of the company's five U.S. cereal plants. It is also asking that Kellogg be required to license new competitors to manufacture its cereals under their labels.[61] The cereal divisions of both General Mills and General Foods would each be divided into two organizations under this proposal. It is impossible to predict either the outcome of this case or when it will be settled.

66 Finally, growth in cereal demand is likely to disappear during much of this decade. In this country, people under 25 years of age are declining in absolute numbers. This group is the largest consumer of cereals. Conversely, the 25- to 50-year-old age group is the fastest growing consumer segment. Presently, this group has the smallest appetite for cereal, with a per capita consumption of just less than one half of the under-25 age group.[62] The industry is already experiencing a dramatic slowdown in cereal demand. During the period 1970–1976, demand for cereal grew at the rate of 7 percent annually. In 1977 and 1978, annual growth averaged only 2 percent.[63] For 1979, it is estimated the industry will experience a 1.5 percent gain.

67 Today, for both General Mills and General Foods, cereals provide only about 10 percent of their total sales volume.[64] Kellogg Company remains predominantly a cereal manufacturer, with a cautious diversification program designed to create a fall-back position in the event opportunities in the cereal industry perceived by the company do not materialize.[65]

[61] "Kellogg: Still the Cereal People," p. 86.
[62] Ibid., p. 81.
[63] Ibid.
[64] Ibid., p. 80.
[65] Ibid., p. 83.

case 3

Republic Steel (A) environmental control—Cleveland district

1 Republic Steel was founded in 1899 with corporate headquarters in Cleveland, Ohio. It was the fourth largest steel maker in the United States with net sales of approximately $3.5 billion in 1978.

2 The Cleveland district was the company's largest steel producing facility, accounting for 35 percent of the corporation's total shipments. It is the largest steel plant in Ohio and one of the top 10 in the United States. Operations conducted within the Cleveland district included blast furnaces, basic oxygen furnaces, primary rolling mills, bar mills, hot and cold strip mills, and a zinc plating line. Also, there were coke ovens for producing a high carbon substance used in iron making; and powerhouses existed for the production of steam and power generation to facilitate the manufacturing operations. Cleveland district capital expenditures exceeded $800 million between 1950 and 1978, of which $161 million was allocated to environmental control equipment and devices.

3 Concern for environmental control continued over the years and required significant planning, investment, and administration.

Environmental control

4 Various kinds of air emissions and waste water are by-products of steel manufacturing. For example, a basic oxygen furnace makes steel by blowing pure oxygen into molten iron and steel scrap. The oxygen combines with the carbon in the molten metal and forms carbon monoxide. This off-gas contains particulate matter that is primarily iron oxide (red dust). Other impurities are removed in the form of liquid slag. If the red dust enters the air, the environment can be affected. Another form of air and water pollution can result from the manufacture of coke used in steel making.

5 Steel manufacturers, government groups, and the public at large have been concerned that excessive quantities of these emissions could damage the environment.

6 **Action by Republic.** The February 1966 issue of *Republic Reports,* "The Fight against Pollution," revealed that various steel companies supported antipollution research programs at Mellon Institute in Pittsburgh since 1938.

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It was also reported in the article that in the post World War II years Republic had been active in minimizing pollution emerging from coke ovens and the open hearth furnaces. Specific actions taken at the Cleveland district were reported to include:

1. A process to be completed in 1969 to eliminate the drainage of waste acids into the Cuyahoga River.
2. Installation of connections to newly constructed city of Cleveland interceptor sewers to redirect the plant's sanitary sewerage from the Cuyahoga River to the city's treatment plants.
3. A recycling system for soluble oil and development of an automatic scale pit cleaning system to make the oil available for reuse in the plant rather than disposal in the river.
4. An electrostatic precipitator system to clean air of emissions from the no. 2 open hearth shop and two new oxygen furnaces.

7 There was increased activity during the 1960s and 1970s by government groups in specifying environmental controls and by Republic Steel in meeting these requirements. The increasing impact of the environmental control program was revealed in the *Republic Steel 1978 Annual Report*. It was reported that almost 20 percent of the corporation's capital outlay in 1978 was for environmental facilities; and pretax profits were reduced by more than $86 million required to maintain and operate environmental control equipment.

8 **Organization for environmental concerns.** Directly concerned on a day-to-day basis were the division of Government Affairs and Environmental Control. Governmental Affairs was headquartered in Washington, D.C. and concerned itself with federal matters as well as directing the activities of the State Government Affairs Department in Cleveland. Charles A. Hesse, assistant director, State Government Affairs, indicated that the mission of his department was to ensure that Republic's interests and opinions were properly considered when the actions of state and local governments affect the corporation or its products. Personnel were required to conduct continued surveillance of state and local legislative and regulatory actions and to maintain ongoing liaison with government an trade association personnel. The department was also a source of information on government contacts, operations, and specific legislation and activity; and it disseminated pertinent information to the corporation and coordinated corporate responses to legislative and regulatory agencies. Also, it administered programs that encouraged employee participation in government and political activities that fostered good citizenship.

9 It was the responsibility of the Republic Steel Division of Environmental Control to coordinate corporate effort in meeting pertinent regulations. William L. West, the current Director, indicated that his group was responsible for interpreting regulations and working within the firm to provide adequate

control devices. This activity included gaining knowledge of the state of technology available to meet the requirements a.ıd suppliers of materials and contractors who could install and build the controls. This Division was also concerned with the monitoring of emissions. David M. Gubanc, Staff Environmental Engineer, analyzed emissions in relation to the standards for control. He was also involved in the economic analysis of emission reduction achieved through additional capital investment. Finally, the Division of Environmental Control cooperated with the Division of Government Affairs in hearings and other public contacts about the role of Republic Steel in environmental controls.

10 The Division of Public Relations, under the directorship of Randall L. Woods, cooperated with the Divisions of Governmental Affairs and Environmental Control in communicating environmental concerns to the concerned publics and government groups.

The coke ovens controversy

11 Indicative of the complexity of meeting environmental regulations for environmental control was the coke ovens controversy. This incident extended from 1974 through 1979 and was not completely resolved at the latter date. The matter was presented in detail in an institutional publication, November 26, 1976. Glen A. Johnson, then director of environmental control, wrote the article as follows.

The Cleveland coke ovens controversy—a review and commentary

For years Republic's Cleveland district has operated six coke oven batteries to produce coke for ironmaking operations at the district's blast furnaces. These batteries, containing a total of 354 separate ovens, have had an annual cokemaking capacity of approximately 2 million tons per year. Coke, of course, is crucially important to the production of steel and accordingly an adquate supply must always be on hand.

A few years ago, it became apparent to Republic's management that the no. 5 Cleveland coke battery built in 1943 would have to be replaced as rapidly as possible with a new mattery. Engineering began promptly and builders of the necessary components of the battery—companies whose capabilities were then very much in demand—were lined up and committed for deliveries in time to have the new battery on stream before the old one was no longer operable. *From the very outset, Republic's plans included the installation of the best available pollution controls on all aspects of cokemaking.*

Pressed to proceed with the construction of the new ovens as soon as possible, Republic commenced field operations in October 1974 in preparation for the erection of the new battery. On October 23, 1974, Republic filed an application with the Ohio Environmental Protection Agency for a permit to install the battery of ovens, specifying the proposed environmental controls. In keeping with prescribed procedures, this application was submitted to the state through the Cleveland Division of Air Pollution Control. On

December 7, 1974, the city of Cleveland asked Republic to submit to it a similar permit application, including additional details and drawings concerning the ovens, their operational and technical features, and environmental controls. At this point, it must be mentioned that even the best coke-oven pollution controls are not capable of fully complying with certain Ohio environmental regulations when interpreted literally. The regulations simply were not drawn up to accommodate the extraordinary technical problems involved in controlling all emissions from such a complex source as a coke battery. However, it was Republic's feeling that recognition of this fact by governmental agencies and realistic negotiations between the company and the agencies would lead to agreement as to the precise controls to be installed and the level of performance to be attained. Nevertheless, the problem led to complications, controversies, and delays in receiving approvals of our permit applications from the state and from the city of Cleveland.

Meanwhile, construction of the vitally needed new coke battery continued and on March 18, 1975, Republic committed itself to the installation of coke-side shed technology to control emissions during the pushing operations, which present the most vexing pollution control problem involved in cokemaking. The shed was to be completed and in operation when the battery was ready for production. At that time, the shed technology—a very costly method—was regarded by the federal EPA as the most satisfactory control approach.

Then we ran into a mid-project technology crisis. As construction of the battery proceeded, we began to receive strong indications that the coke-side shed method of control might not be acceptable to the federal Occupational Safety and Health Administration (OSHA). *In other words, the problem lay not with any unwillingness on Republic's part to install satisfactory pollution controls but rather with an inability on the part of the various governmental agencies involved to decide what kind of pushing controls would be acceptable.* After the passage of many months without satisfactory resolution of this problem, Republic on September 3, 1975 withdrew its commitment to install a coke-side shed in order to avoid the possibility of spending millions of dollars on a control system that might end up being unacceptable. However, Republic recognized that pushing controls, in some form, were needed and that the company would be expected to install whatever control technology was approved by all of the governmental agencies involved.

Late in 1975 and in early 1976—more than a year after Republic submitted its permit applications—the applications were denied by both the state and the city, principally on the grounds that the pushing control controversy had not been resolved. The attention given these denials brought Cleveland's City Council and the media into the dispute and resulted in Republic's receiving a great deal of adverse publicity for purportedly seeking to construct and operate a battery without adequate pollution controls.

After months of extensive negotiations with the various governmental agencies involved, consent agreements were signed in July 1976 with the city and state environmental protection agencies. Under these agreements, Republic was authorized to operate the battery provided the company

selected an acceptable pushing control technology by September 1 of this year and agreed to have the controls in operation by September 1978. By this time, there were strong indications that the acceptable technology would be either the one-spot quench car—a system costing about $5 million—or an alternative method being developed by the Donner-Hanna Coke Corporation in Buffalo. Federal authorities participated in these negotiations and subsequently also signed a consent order with Republic containing terms similar to those with the city and state. These actions by the involved parties seemed sensible and equitable, since Cleveland's air quality would benefit by the shutdown of the old battery and since even without pushing controls the new battery would be far cleaner than the battery it was replacing. So, at long last it appeared the problem of satisfying all of the governmental environmental control agencies had been resolved and that the way was cleared for a smooth transfer of cokemaking from the old battery to the new one.

Subsequent events proved this to be optimistic. To begin with, the old battery deteriorated even faster than had been anticipated and in July it had to be withdrawn from service to protect the safety of employees working at the facility. This put Republic into a severe race against time in the effort to get the new ovens on stream and producing coke before our Cleveland coke supply diminished to the point where we could not adequately sustain the required production of steel and keep our normal work force employed.

But this proved to be the lesser of the unforeseen problems that were to plague Republic's efforts. After the company was well along with the 60- to 90-day oven heating and seasoning process required prior to actual cokemaking, citizen groups known as The Neighborhood Environmental Coalition, challenged Republic's agreements with the city and state and requested public hearings before the Ohio Environmental Board of Review—hearings which they hoped would lead to a denial of cokemaking by the new battery until all pollution controls were installed.

This action led to weeks of involved hearings during which the board, on October 8, issued an order prohibiting the startup of cokemaking by the battery until even further hearings could be held and a final decision on the plea of the citizen groups could be rendered. At that time, the board also established the requirement that the citizen groups post a bond of $5,000, ostensibly to compensate Republic for losses incurred by the delay should the company's position ultimately prevail. (As a practical matter, the compensatory worth of the bond was insignificant, since the delay was costing Republic *each day* several times the value of the bond.)

When the board attempted to delay the hearings, Republic appealed to the Ohio Supreme Court asking that the board be ordered to proceed with the additional hearings without interruption or delay. On October 27, the Supreme Court ruled in Republic's favor and ordered the board to proceed with further hearings without interruption. Two days later, based on an earlier legal action by Republic, the Ohio Court of Appeals in Cuyahoga County found that the board's order prohibiting coke production by the battery was invalid, thereby seemingly paving the way for the startup of the battery.

But, again, this proved not to be the case, because on November 1, the

citizen groups filed a new motion with the Environmental Board of Review seeking a second order prohibiting startup of the battery. The board complied with this request by issuing a second order prohibiting the startup of cokemaking, again requiring the posting of a $5,000 bond. Republic again appealed to the Ohio Court of Appeals contesting this second action by the board, and a ruling of the court is awaited.

To grasp the breadth of participation in this wasteful procedural controversy that has consumed more time in the effort to obtain permits than was required to construct the facilities themselves, the following is the list of organizations and institutions involved in the dispute:

- Republic Steel Corporation
- Cleveland Division of Air Pollution Control
- Cleveland Board of Building Standards and Appeals
- Ohio Environmental Pollution Authority
- U.S. Environmental Pollution Authority
- Ohio Environmental Board of Review
- Cleveland City Council
- Cuyahoga County Court of Common Pleas
- Cuyahoga County Court of Appeals
- Ohio Supreme Court
- Ohio Attorney General
- The Neighborhood Environmental Coalition
  - Northern Ohio Lung Association
  - Southwest Civic Association
  - Broadway United Methodist Church
  - Broadway Christian Church
  - Broadway Retirees Fellowship
  - Forest City Civic Association

Despite the regulatory ordeal just described, Republic intends to persevere in its efforts to achieve an equitable resolution of this issue. But the episode serves as a striking example of the difficulties a company can face in seeking to make an improvement that will benefit everyone concerned.

12 **Tentative resolution.** A consent decree was issued by the federal Court of Appeals in December 1976. Republic Steel opened the new coke ovens battery in January 1977. In excess of $8 million was spent for emission controls in this new $30 million facility. The original design included all emission control facilities except pushing emission control. Republic was in the process then of installing pushing emission control. Pertinent air emission controls and Republic's performance are summarized as follows:

1. Federal Environmental Protection Agency.
   a. Control of emissions when charging batteries with coal and containment of leaks through doors, lids, etc.

Standard: No visible dust for more than 84 seconds over seven consecutive charges.

Republic Steel performance: Meets standard.

b. Pushing emissions, occurring when unloading finished coke from coke ovens into quenching cars.

Standard: Not greater than 0.03 lbs. of particulate matter per ton over 90 percent of total activity of pushing coke into quenching cars.

Republic Steel performance: Cannot meet standard; results from 0.05 to 0.06 lbs. per ton under existing technology.

2. City of Cleveland Division of Air Pollution Control (with cooperation of Ohio EPA) pushing emission limitations.

Standard: 0.1 lb. of particulate matter per dry ton of coal charged, or 0.8 lb. of particulate matter of coke produced.

Republic Steel performance: See (*b*) above. The standard is met and is four times less demanding than the federal standard.

13 The consent decree included the provision that the standards for pushing emission controls must be met by September 1978. However, when it became known that the state of technology would not make this possible, an extension until September 1979 was granted. As this latter date was approached, there was little confidence that a technological breakthrough would occur to enable the corporation to conform.

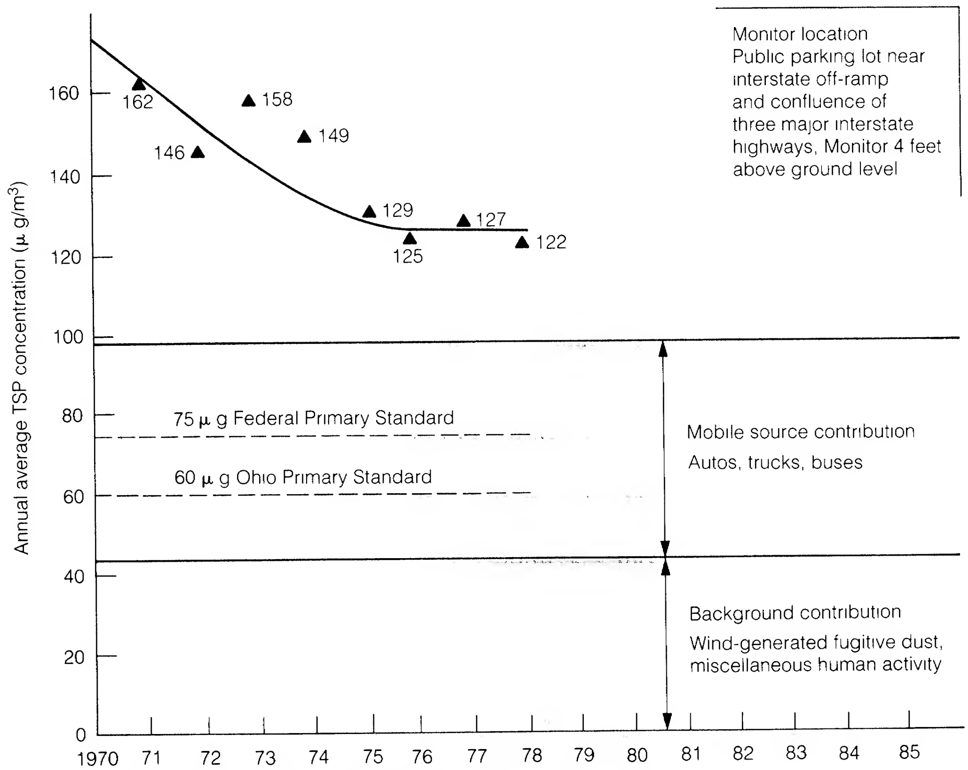
The future—ambient air quality standards and source performance standards

14 The passage of the Federal Clean Air Act of 1970 established clean air as a national goal and set up a regulatory organization with the responsibility of achieving the goal within a specified period of time. The agency first defined *clean air* by establishing air quality standards. These are concentrations of specific air pollutants that will not affect human health under conditions of long-term exposure. This standard is called the primary air quality standard'' or ''health standard.'' The primary air quality standard for total suspended particulate (TSP) is an annual average concentration of 75 micrograms per cubic meter, and a 24-hour maximum of 260 micrograms per cubic meter. Subsequent regulations concerning emission performance such as the coke oven emission limitation described in the previous section were written to reflect the technological state of the art of air pollution control. The agency proceeded on the premise that if point sources of pollution conformed to the mandated performance standards which were technology based, then the primary air quality standards would be achieved.

15 The Cleveland air monitoring network has one station located in a public parking lot that reports its daily average readings of ambient air quality to the media which then disseminates the information to the general public. The 1978 annual average TSP concentration recorded at this station was 122 micrograms/cubic meter which exceeded the primary air standard by 47 micrograms. Exhibit 1 shows the eight-year trend of the annual average TSP level. Analysis of the 1978 TSP level by source reveals the following.

Contributing source	*Total suspended particulates (TSP) in micrograms per cubic meter*
Wind-generated fugitive dust, miscellaneous human activity	42
Autos, trucks, buses	55
Other, including Republic Steel	25
Total	122

exhibit 1
Total suspended particulate at St. Vincent monitoring station, Cleveland, Ohio



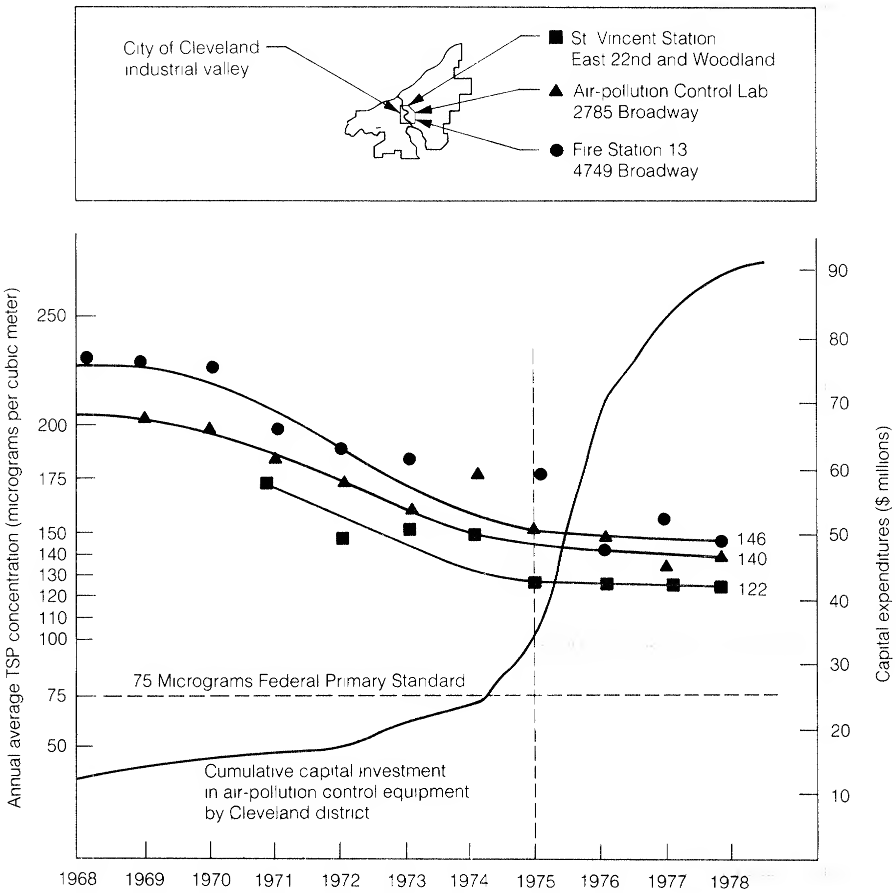
Source: Republic Steel, Environmental Control Department, April 1979.

16 Exhibit 1 and the TSP data reveal that the 75 microgram per cubic meter TSP health standard is exceeded by background levels and mobile source contribution before any industrial or point source pollution is added to the ambient air.

17 David M. Gubanc noted that the regulatory agencies recognized the invalidity of the premise that controlling point source pollution would result in air quality that met the primary air quality standards. The U.S. EPA stated as much when it submitted an urban particulate assessment study for Cleveland in 1976 that concluded that despite full compliance by point sources with mandated emission limitations, a few air monitoring stations would continue to exceed the TSP standards due to the topography, land use patterns, and meterology of the area. Rather than deal with this false premise,

exhibit 2

Annual average air quality measurements (total suspended particulates) and Republic Steel Cleveland District's capital investment in air pollution control equipment



Source: Republic Steel, Environmental Control Department, April 1979.

the public strategy of the agency and legislative bodies was to extend the legislated dates for primary air quality standard attainment from 1975 to the end of 1982. The agency then continued to insist upon additional industrial source control based on the same premise it had proven false through its own assessment study.

18 West and Gubanc expressed their firm's concern for the increased capital outlays for environmental control capital equipment and the decreasing rate for achieving reductions in air pollution. The Environmental Control Division of Republic compared the cumulative capital investment in air pollution control equipment to TSP concentration trends at the air sampling stations closest to Republic's Cleveland district as shown in Exhibit 2. Measurements taken at the three air quality monitoring stations in Cleveland revealed approximately equivalent geographical effectiveness in reducing pollution; but the rate of return in air quality to investment was decreasing markedly.

19 There were heavy capital outlays for point source emission controls by other industries within the urban area. The possibility remained that other solutions should be considered.

case 4

Republic Steel (B) public awareness and attitude program

1 The Cleveland district of the Republic Steel Corporation assumed a low profile to the public for many years. Although the corporation wanted to be known as a good citizen in the community which supported civic endeavors and provided jobs, income, and nationally needed products, there was no active strategy to communicate and build this image. Little was done to inform business, government, civic groups, and the public at large of the firm's contributions and importance in the community.

2 Possibly, the highest visibility resulted from the incident referred to as the coke oven controversy. For three years Republic was involved with government and civic groups in obtaining a permit to build a new coke oven battery. The matter of environmental controls was the source of the controversy, and publicity was not always favorable for Republic.

3 In 1976, it became apparent that Republic Steel should review its low profile strategy and consider an active program of informing the public as to its role and contributions to the community.

Corporate background

4 The Republic Steel Corporation was founded in 1899 with headquarters in Cleveland, Ohio. It is the fourth largest in its industry and employs 41,400 persons and had net sales of approximately $3.5 billion in 1978.

5 As indicated in the *Republic Steel 1978 Annual Report,* this firm is a major integrated steel company that produces diversified steel mill products and a variety of fabricated steel products. These steel products are manufactured in 15 states and Ontario, Canada. In addition, this corporation owns and operates raw material reserves, principally for its own use. Included are iron ore, coal, limestone, and natural gas; and Republic has a 50 percent interest in Reserve Mining Company, a major domestic producer of taconite pellets. Finally, Republic has stock ownership in companies owning, operating, and chartering ocean vessels carrying iron ore and other bulk materials.

6 **Cleveland district.** The corporate headquarters and extensive production facilities are located in Cleveland. These include a steel plant and a steel and

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tube manufacturing division. Included in these operations are: blast furnaces, basic oxygen furnaces and auxiliaries, hot scarfing machines, hot and cold strip mills, and rolling mills. Also, there are coke ovens for producing a high carbon substance used in steel making; and powerhouses for the production of steam and power generation to facilitate the manufacturing operations. Capital expenditures for these facilities have exceeded $800 million since 1950. In January 1979 the firm announced a $200 million program to modernize and enhance the plant's capability to supply its major flat rolled steel customers, particularly the automotive industry.

7 The following facts indicate further the importance of Republic Steel to the Cleveland community: (1) 9,300 employees, making it the largest employer in the area, (2) $2.5 million payroll weekly, (3) $10.5 million annual payments in property taxes, and (4) the purchase of goods and services locally from 1,500 local businesses in excess of $250 million annually.

Pollution and its control

8 Various kinds of pollution are by-products of steel manufacturing. For example, a basic oxygen furnace makes steel by blowing pure oxygen into molten iron and steel scrap. The oxygen combines with the molten metals and forms carbon monoxide. This off-gas contains particulate matter that is primarily iron oxide (red dust). Other impurities are removed in the form of liquid slag. If the red dust enters the air and the acids from liquid slag enter the water, this pollution can affect the environment. Another form of air and water pollution can result from the manufacture of coke used in steel making.

9 Steel makers, government, and the public at large have been concerned over the years that excessive quantities of these pollutants damage the environment.

10 **Action by Republic.** The February 1966 issue of *Republic Reports,* "The Fight against Pollution," revealed that various steel companies had supported antipollution research programs at Mellon Institute in Pittsburgh since 1938. It was also reported in the article that in the post-World War II years Republic had been active in minimizing pollution emerging from coke ovens and the open hearth furnaces. Specific actions taken at the Cleveland district were reported to include:

1. A process to be completed in 1969 to eliminate the drainage of waste acids into the Cuyahoga River.
2. Installation of connections to newly constructed city of Cleveland interceptor sewers to redirect the plant's sanitary sewerage from the Cuyahoga River to the city's treatment plants.
3. A recycling system for soluble oil and development of an automatic scale pit cleaning system to make the oil available for reuse in the plant rather than disposal in the river.

4. An electrostatic precipitator system to clean air of emissions from the no. 2 open hearth shop and two new oxygen furnaces.

11 There was increased activity during the 1960s and 1970s by government groups in specifying antipollution controls and by Republic Steel in meeting these requirements. Indicative of this emphasis in the Cleveland District was the expenditure of $89 million for pollution control between 1951 and 1975, of which nearly 90 percent occurred after 1970.

12 **The coke oven incident.** In 1974, the decision was made to replace one of the six coke oven batteries which had been built in 1943. Such projects were complex; materials were scarce; and builders of coke batteries were in high demand. To avoid long waits and the loss of capacity of the batteries being replaced, the custom of the industry was to proceed rapidly in lining up materials and contractors and start construction when permits were filed with the various government agencies for these installations. These actions were taken, and the permit request was filed on October 23, 1974.

13 Various objections were voiced by local, state, and federal government agencies that the new installation would not meet all health and safety and environmental control requirements. It was the contention of Republic Steel that (1) some of the regulative requirements were not clear as to what should be done to meet them; (2) that technology was not sufficiently advanced to meet other requirements; and (3) that the corporation was eager to negotiate a reasonable solution as was the usual procedure for past construction by Republic and other members of the industry.

14 In late 1975 and early 1976, more than a year after the permit applications had been filed, they were denied by both the state and the city, primarily on the basis that emission would not be controlled according to regulations. The regulations in question were not drawn up to accommodate the technology problems involved, according to Glenn A. Johnson, then director of environmental control.

15 After three years, permits were received; and the new coke oven battery was opened in January 1977. During this period of time government, civic groups, and the media were involved. There was adverse publicity and the belief by some that Republic Steel should be required to meet regulations, regardless of their ambiguity and lack of recognition as to the state of technology in providing for the control devices. The groups involved in the matter were summarized by Glenn A. Johnson as follows:

Republic Steel Corporation
Cleveland Division of Air Pollution Control
Cleveland Board of Building Standards and Appeals
Ohio Environmental Pollution Authority
U.S. Environmental Pollution Authority
Ohio Environmental Board of Review
Cleveland City Council

Cuyahoga County Court of Common Pleas
Cuyahoga County Court of Appeals
Ohio Supreme Court
Ohio Attorney General
The Neighborhood Environmental Coalition
Northern Ohio Lung Association
Southwest Civic Association
Broadway United Methodist Church
Broadway Christian Church
Broadway Retirees Fellowship
Forest City Civic Association

Strategy to increase public awareness and favorable attitudes

16 **The concept.** Republic Steel believed that action should be taken to increase the public awareness of its activities, contributions to the community, and efforts to establish effective pollution controls. L. T. Young, director of marketing and advertising communications, indicated that the public had scarce information about and understanding of his firm. For example, substantial support was given to civic groups, charities, and the Cleveland Orchestra; however, these activities had not been publicized.

17 Randall L. Woods, director of public relations, related the firm's concern about the public's lack of knowledge and adverse reactions among the news media and local groups to Republic's pollution control measures. Meldrum and Fewsmith, Inc., Republic's advertising agency, indicated in an action proposal that:

> lack of awareness . . . makes members of the community groups more receptive to vocal critics of Republic whose attacks frequently contain distorted information, whose charges are emotionally appealing, and whose demands indicate a lack of understanding of the problems facing those who must devise, construct, and finance equipment to reduce or eliminate industrial emissions. . . .

18 Meldrum and Fewsmith had run an environmental control communications program in 1971 for Republic in Cleveland, Chicago, and Buffalo over a three-month period. The results showed that there were dramatic changes in awareness and attitudes held by the public. Important findings were (1) attitudes toward Republic changed because of their specific environmental control programs, and (2) public awareness of Republic's efforts varied quite closely with the intensity of the communications program.

19 Thus, it was determined that a new reportorial communications program should be run to increase public awareness and provide a basis for the public forming attitudes toward Republic Steel.

20 **The program.** Meldrum and Fewsmith was retained to conduct the program, and presented tentative objectives which are summarized as follows:

Corporate objectives

1. Reduce public criticism of Republic as it relates to environmental control and a lack of accurate information about what Republic has done to control industrial emissions.
2. Increase public acceptance and support of Republic Steel as a community good neighbor in the specified audiences.

Communications objectives

1. Increase awareness and understanding in Cleveland mill-fence-line communities, general public, and target "thought leader" audiences of what Republic Steel has done, is doing, and plans to do to control industrial emissions and the relative costs of these actions as they relate to viability of the Cleveland district.
2. Increase awareness of Republic Steel as a good neighbor that is doing its best to protect the environment and maintain employment as a result of maintaining itself as a reliable supplier of steel to the marketplace.
3. Increase awareness of Republic's contributions to the community: employment, taxes, etc.

Tactical objectives

1. The program is to be comprehensive, straightforward, reportorial, and use a multimedia campaign format based on a common theme.
2. The tone and degree of impact created should be midrange. Sufficient impact and frequency of message should be developed to assure that audiences will receive messages. But overstatement should be avoided. All problems are not solved; steel making will always be a dirty process. Communicate in a rational approach that Republic has done a lot to solve its problems, quite a lot, and there are dramatic improvements and public benefits, but no implication should be made that the job is finished.
3. The primary audience is located within a two-mile radius of the Cleveland district and is described in this campaign as "fence-line community." But the publics of the entire city of Cleveland and its suburbs are equally important to Republic in its quest for an informed public.
4. Substantive, technical communications content would be based on information contained in Cleveland district environmental data sheets, April 1978, and counsel of G. A. Johnson, director of environmental control, and David M. Gubanc, staff environmental engineer.

21 The current program was patterned after the 1971 environmental control communications program. Plans were made for (1) a benchmark survey of the community to determine existing awareness patterns and attitudes, (2) a corporate advertising program, and (3) a postcampaign survey of the community to determine possible changes in awareness and attitudes.

The benchmark survey

22 The benchmark survey was designed by Meldrum and Fewsmith in consultation with Republic Steel. Its specific purpose was to establish base levels against which future changes, as measured in follow-up studies, could be

compared. Changes between the benchmark and follow-up studies findings would be evaluated in terms of total communication program contribution. The sample selection, field work, and preliminary findings were completed by Business Research Services, Inc. of Cleveland. Interviewing began May 3, 1978 and was completed on May 6, 1978, so that the corporate advertising program could be started during May.

23 **Research design.** (1) *Sample.* Householders were chosen as the group to be interviewed. The city of Cleveland, which surrounds the Republic Steel facilities, was chosen as the area of study. Next, it was recognized that those persons living within two miles of the installation were affected particularly by any unfavorable industrial environment. This group was defined as the fence-line community; and they could be identified and selected by using a crisscross directory for the census tracts within the two-mile range of Republic. The decision was made to choose a sample consisting of 600 respondents. Because one third of the households were located within two miles of Republic facilities, 200 were to be selected randomly from the fence-line communities and 400 from the remainder of the city of Cleveland. (2) *Method of collecting information.* The survey was conducted by means of telephone calls to householders as described above. (3) *Questionnaire.* It was designed to obtain the respondents' knowledge and perceptions about (*a*) causes of pollution, (*b*) which industries and firms caused it, (*c*) effect, concern, and control of pollution by the three leading steel manufacturers in Cleveland, and (*d*) impressions about Republic as to its contribution to the city as a citizen and economically. Not only was this information to provide a base line for measuring changes after the institutional advertising campaign, but it was to provide information as to items to be communicated for better awareness and perceptions.

24 **Findings.** A summary of findings was included with the detailed report submitted by Business Research Services. (See the Appendix for comparative tables containing condensed information about this and the postcampaign survey.) This study was interpreted in a memorandum by Bruce Childers, director of research, for Meldrum and Fewsmith as follows:

> . . . Republic Steel is considered as a good company . . . beneficial to the community . . . however, there is a lack of specific knowledge of the environmental control steps taken and the magnitude of these steps, as well as the contribution to the community in terms of employment, salaries, and taxes.
>
> . . . the steel industry and Republic Steel are seen as major contributors to pollution—particularly air pollution . . . Republic is seen as . . . trying to control pollution. But, a sizable portion of the respondents were unable to make an assessment of efforts in general or specific terms.
>
> . . . the three steel companies in the area . . . were rated about equally on "efforts to control air and water pollution," "concern for Cleveland's environment," and "support of the community."

. . . due to Republic's higher visibility, I would expect to see a much more critical view of the environmental issues and a more positive view on the community support issue. We could assume that this "similar" rating of the three companies is due to a lack of awareness of specific company environmental control efforts or contributions to the community.

. . . there appears to be a feeling that while Republic is thought of as a major cause of pollution, they are also thought of as being important in the area.

To summarize. . . . First, the attitudes toward Republic are a good foundation upon which to build . . . the communication program need not concentrate on the difficult task of reshaping, rebuilding, or even reversing basic attitudes. A positive base is imperative if desired messages are to be accepted rather than rejected. Second, . . . an awareness void exists in terms of specific environmental control accomplishments, efforts, and contributions to the community. These two points indicate that the communication of basic hard facts about accomplishments and contributions will be accepted and are necessary to overcome the awareness void.

25 The research study and Bruce Childers' analysis were forwarded to Republic by Norton I. Satz, senior vice president and account executive for Republic Steel. He recommended that the findings and interpretations be used as the base line of awareness and attitudes; and they should be used also in composing the content of the advertising program.

Corporate advertising program

26 A multimedia advertising program, based upon the benchmark survey findings, was established to present facts about Republic Steel. This program was run from mid-May through mid-November 1978.

27 **Messages.** The advertising messages covered both air and water pollution controls used by and the economic impact of Republic Steel in the community. The messages were allocated by subject and media as follows:

	Percent of messages by topic	
Media	*Economic*	*Pollution*
Television	21%	79%
Radio	2	98
Print media	15	85

28 They were classified under the categories of (1) pollution control, which included scrubbers, water treatment, red dust, coke oven gases, and smoke; and (2) economic impact, which included payroll number of employees, investment and taxes paid. (See Appendix Exhibits 1, 2, and 3.)

29 Typical of message content was the story told in the 60-second TV commercial entitled, "Coke." Appropriate film showed a coke oven in operation. The following key phrases are representative of the message:

Spokesman: [*on camera*] In these big ovens at Republic Steel, coal is converted into coke.

We have to do this, because coke is something we absolutely need as an ingredient when we're making steel.

[*open oven*] What you're looking at now is the usual way that the red hot coke is emptied from an oven, cooled and transported.

Up to now, it has always been pushed into an open quench car.

That makes for a lot of smoke and gas . . . and a tough, environmental problem.

[*on camera*] But technology is catching up—and now Republic Steel is beginning to use a new kind of *closed* quench car, designed just to solve this problem.

The hot coke is never in the oven, but it is pushed directly into the car, where the dirty gases are captured and cleaned by water sprays.

What comes out the exhaust vent is only steam and cleaned gas.

It's another way we're working at Republic Steel to make Cleveland a *better* place for all of us.

30 **Media and schedules.** Detailed information about the media and schedules are presented in Appendix Exhibits 1, 2, and 3. The media mix tactical decisions included:

1. A variety of media was needed to reach a broad socioeconomic audience range.
2. Radio and television (considering station and time selections) were chosen to reach industrial plant employees and municipal government, Cleveland voters, and other important audiences. Considered also was the necessity to reach black and ethnic audiences.
3. Newspapers, citywide, plant neighborhood, foreign language, ethnic, and black, were used to contact the target publics.
4. The upscale audiences, thought leaders, community influentials, and those who sway opinions within the city were reached through two Cleveland media networks—business and opinion. The affluent, young, active, pacesetters were reached through *Cleveland Magazine*. This package covered that segment of the market having upper educational, income, and managerial/professional demographics.
5. Outdoor billboards were used to contact the mobile and pedestrian traffic, particularly within the fence-line community area.

31 To the extent possible, an alternating strategy of heavy and maintenance message exposure was carried out. This followed the principle that concentrated exposure is required to penetrate and command attention; and once this is achieved, fewer exposures are required to maintain the level of awareness for a short period of time. Then, the cycle must be repeated. Finally, media usage was to be held below the "irritation-factor level" that can occur with heavy sustained exposures.

Postcampaign survey and findings

32 This portion of the program was conducted in mid-November 1978 and after six months of the corporate advertising program. It was designed to measure

pertinent changes between May 1978 and November 1978 in awareness and attitudes of the Cleveland public. This second survey was designed and conducted identically to the benchmark survey to obtain comparable data. Meldrum and Fewsmith and Business Research Services assumed the same responsibilities as they had for the May survey.

33 **Summary findings.** Because of their roles in designing the program and serving as the agency for the corporate advertising phase, Meldrum and Fewsmith requested that Business Research Services summarize the findings and report them directly to Republic Steel. Summary tables prepared by the research firm are included in the Appendix. The interpretations presented below were extracted from the Business Research Services report.

34 *1. Overview.* The corporate advertising campaign was highly successful in informing the public of Republic Steel's pollution control efforts and its position in the community. There were positive changes in public attitudes and perceptions since the start of the campaign.

35 *2. Changes in awareness of pollution control.* Awareness of Republic's pollution control efforts changed significantly. Increases from May to November of 300 percent and 171 percent occurred in the fence-line area and the remainder of Cleveland, respectively. (See Appendix, Table 1A.) Not only was the fence-line community more aware, but 37 percent were able to cite corrective action taken to include water filtration and 23 percent named new systems to filter smoke stacks and other devices for air purification. (See Appendix, Table 1B.)

36 *3. Perceptions about the control of pollution.* Republic was viewed as doing the best job of controlling air and water pollution at the end of the corporate advertising program. (See Appendix, Table 2.) In fact, it was the only one of the three steel firms whose measurements increased significantly. This is particularly significant when it is noted that no one company was really distinguished as doing the best job of pollution control in the benchmark survey.

37 *4. Favorable impressions of pollution control efforts.* The respondents were asked to rate the three steel companies in four characteristics: efforts to control air pollution; efforts to control water pollution; concern for Cleveland's environment; and overall support of the community. The results contained in Appendix, Table 3 revealed that Republic increased its favorable ratings in every measurement in both samples. The ratings given by the fence-line respondents who live nearest the industrial areas are of particular interest. Their attitudes toward the other two steel companies did not change significantly in any of the four measurements since the benchmark survey. However, attitudes toward Republic Steel were more positive in every measurement.

38 *5. Republic as a corporate citizen.* Although specific economic facts were not known by the respondents, they indicated that Republic was valuable to Cleveland, because it provided jobs. (See Appendix, Tables 4A and 4B.) There was a dramatic change in opinion between May and November

concerning Republic's attempt to clean up pollution. There were 525 percent more respondents in the fence-line area and 125 percent more in the remainder of Cleveland who believed that Republic Steel was trying to stop pollution. In summary, Republic Steel was rated as good to have in the community.

39 6. *Increased awareness of steel industry as a polluter.* Business Research Services noted that the advertising program not only increased knowledge of efforts to control pollution, but also called attention to pollution. (See Table 5.) The increased recognition of pollution caused by steel makers was limited to the fence-line sample and water pollution. Business Research Services said: "The problems of pollution are very real . . . to fence-line residents . . . it is logical to expect a more intense, more personal reaction to a pollution advertising campaign among fence-line respondents than among respondents from the city as a whole."

Appendix

exhibit 1

1978 corporate advertising program (television)

Commercials run during test period:
  Benchmark interviewing completed May 6, 1978
  Follow-up interviewing completed November 1, 1978

Total commercials:
  177—60s, 10—30s during test period.

Commercial title		*Times run*	*Basic subject*
Pockets	60 sec.	36	Economic
	30 sec.	4	Economic
Coke	60 sec.	56	Environmental control
	30 sec.	6	Environmental control
Red Dust	60 sec.	32	Environmental control
Water Treatment	60 sec.	53	Environmental control

By basic subject:
  Economic, 36—60 sec; 4—30 sec. (21%)
  Pollution, 141—60 sec; 6—30 sec. (79%)

Stations used:
  WKYC = 52; WJW = 54; WEWS = 36; WUAB = 45

Time period:
  Early and late news, prime rotator (3, 5, and 8); prime movie (43)

Number of spots by week:
  First spots—mid-August 1978
  8/14/78 = 22—60s; 8/21/78 = 17—60s; 8/28/78 = 23—60s; 9/3/78 = 17—60s
  9/11/78 = 21—60s, 2—30s; 9/18/78 = 19—60s, 4—30s; 10/9/78 = 19—60s, 4—30s
  10/16/78 = 23—60s; 10/23/78 = 16—60s posttest conducted
  10/30/78 = 15—60s, 2—30s; 11/6/78 = 18—60s; 11/27/78 = 17—60s
  12/4/78 = 17—60s; 12/11/78 = 17—60s

exhibit 2

1978 corporate advertising program (radio)

Commercials run during test period:
  Benchmark interviewing completed May 6, 1978
  Follow-up interviewing completed November 1, 1978

Total commercials:
  1,064—60 sec. spots during test period.

Commerical title		*Times run*	*Basic subjects*
Scrubber	(R3)	76	Environmental control
	(R1)	55	Environmental control
Water treatment	(R2)	115	Environmental control
	(R5)	276	Environmental control
Red dust	(R4)	203	Environmental control
Coke	(R6)	317	Environmental control
Investment	(R8)	11	Economic
	(R7)	11	Economic

By basic subject:
  Pollution control—1,042 (98%); economic—22 (2%)
  First spots end of May 1978

Stations used:
  WZAK-FM, WERE-AM, WJMO-AM, WHK-AM, WQAL-FM, WWWE-AM

exhibit 3
1978 corporate advertising program (print media)

Ads run during test period:
Benchmark interviewing completed May 6, 1978
Follow-up study interviewing completed November 1, 1978

Publication	*Number and size ads*	*Time period/month run*
IMC Reporter	2—2P4CB	September and October
Bring Back Broadway Program	1—1PB&W	October
Cleveland Athletic Club Roster	1—1P4CB	September
Torchlight Roster	1—1P4CB	September
Ad Club News	2—1/3PB&W	September and October
Plain Dealer	11—7cx215 lines	May 6–October 19
Program-Tennis Tournament	1—1PB&W	July
Cleveland Press	11—7cx215 lines	May 6–October 19
Call & Post	8—7cx215 lines	May 20–October 21
Neighborhood News— Garfield Hts Tribune	6—7cx215 lines	May 17–October 4
American Home (Slovenian)	8—6cx210 lines	May 26–October 19
Driva (Lithuanian)	8—5cx224 lines	May 26–October 19
Hungarian News	9—6cx210 lines	May 25–October 19
Kuryer (Polish)	6—6cx210 lines	May 25–October 12
Wolksblatt (Saxon-German)	9—6cx210 lines	May 22–October 16
Szabadsag (Hungarian)	8—6cx210 lines	May 26–October 20
Wachter & Anzeiger (German)	8—6cx210 lines	May 26–October 20
Com Corp— Sun Herald	7—7cx215 lines	June 22–October 19
Lakewood Sun Post		
News Sun		
Parma Sun Post		
West Side Sun News		
Sun Currier		
Sun Press		
Sun Messenger		
Southeast Sun		
Herald Sun		
Strongsville-Royalton Sun Star		
Cleveland Business Network	2—1P4CB	August and October
Cleveland Opinion Network	1—1P4CB	September
Cleveland Magazine	3—1P4CB	July, September, and October
Billboards:		
Airport		August, September, and October
Huron Road		August, September, and October
Westside/Superior Bridge		October
Rotating Boards (34 boards)		July, August, and September

Total ads: 114 run during test period

Ad title	*Times run*	*Basic subject*
Pockets (A-2484)	17	Economic
Smoking habit (A-4568)	28	Environmental control
Coke (A-4509)	13	Environmental control
Water treatment (A-4598)	38	Environmental control
Water treatment (A-4497)	6	Environmental control
Super scrubber (A-4498)	12	Environmental control
Billboards/smoking habit (A-4570)		

By basic subject: Pollution control—97 ads (85%); economic—17 ads (15%)

table 1A

Question: *Are you aware of anything that has been done or is being done by any of these companies to control air and water pollution? (If yes) Which company?*

Awareness or Republic's efforts to control air and water pollution increased significantly since May 1978: In Cleveland, Republic's measurement went from 17 to 46 percent, a 171 percent increase. In the fence-line, Republic's measurement went from 15 to 60 percent, a 300 percent increase.

Awareness of pollution control efforts

	City of Cleveland					*Fence-line*				
	May	*November*	*Percent change*	*Point change*	*Signi-ficant*	*May*	*November*	*Percent change*	*Point change*	*Signi-ficant*
Yes, Republic	17%	46%	+171	+29	Yes	15%	60%	+300	+45	Yes
Yes, Jones & Laughlin	7	8	+ 14	+ 1	No	4	8	+100	+ 4	No
Yes, U.S. Steel	7	7	0	0	No	4	5	+ 25	+ 1	No
Base	(400)	(400)				(200)	(200)			

table 1B
Question: *What do you recall has been done or is being done by Republic Steel to control air and water pollution?*

Thirty-seven percent (37 percent) in the fence-line, and 24 percent in Cleveland recalled Republic's water filtration facility; and 23 percent in the fence-line and 10 percent in Cleveland recalled Republic's air filtration systems.

Recall of Republic's activity to control pollution

	City of Cleveland					*Fence-line*				
	May	*November*	*Percent change*	*Point change*	*Signi-ficant*	*May*	*November*	*Percent change*	*Point change*	*Signi-ficant*
New system for smoke stacks/ screens and filters installed to purify air	7%	10%	+ 43	+ 3	No	6%	23%	+ 283	+17	Yes
Water filtration facility/ improved water pollution control methods	3	24	+700	+21	Yes	1	37	+3600	+36	Yes
Making a general effort to fight pollution/spending money on improvements	1	8	+700	+ 7	Yes	7	12	+ 71	+ 5	No
Base	(400)	(400)				(200)	(200)			

table 2

Question: *Which one of these companies do you feel is doing the best job of controlling air pollution? . . . The best job of controlling water pollution?*

Perceptions of Republic doing the best job of controlling air pollution increased 126 percent in Cleveland (from 23 to 52 percent) and 108 percent in the fence-line (from 25 to 52 percent). Perceptions of Republic doing the best job of controlling water pollution increased 194 percent in Cleveland (from 17 to 50 percent) and 194 percent in the fence-line (from 17 to 50 percent).

Best job of controlling pollution

	City of Cleveland					Fence-line				
	May	*November*	*Percent change*	*Point change*	*Significant*	*May*	*November*	*Percent change*	*Point change*	*Significant*
Best job of controlling air pollution:										
Republic	23%	52%	+126	+29	Yes	25%	52%	+108	+27	Yes
U.S. Steel	18	15	− 17	− 3	No	21	11	− 48	−10	No
J&L	13	17	+ 31	+ 4	No	18	13	− 28	− 5	No
Best job of controlling water pollution:										
Republic	17	50	+194	+33	Yes	17	50	+194	+33	Yes
U.S. Steel	12	13	+ 8	+ 1	No	12	10	− 17	− 2	No
J & L	8	14	+ 75	+ 6	Yes	11	9	− 18	− 2	No
Base	(400)	(400)				(200)	(200)			

table 3

Question: *I'd like you to rate three steel companies in the Cleveland area on several characteristics. Let's use a scale of from 1 (lowest, most unfavorable rating) to 5 (highest, most favorable rating).*

Republic Steel significantly increased its favorable ratings (5 and 4) in every measurement in both samples. Republic's largest increase in Cleveland was in efforts to control water pollution, which increased 135 percent; Republic's largest increase in the fence-line was in concern for Cleveland's environment, which increased 93 percent.

Positive ratings of characteristics*

	City of Cleveland					Fence-line				
	May	*November*	*Percent change*	*Point change*	*Signi-ficant*	*May*	*November*	*Percent change*	*Point change*	*Signi-ficant*
Efforts to control air pollution:										
Republic Steel	22%	42%	+ 91	+20	Yes	22%	34%	+55	+12	Yes
J&L	16	21	+ 31	+ 5	No	19	14	−26	− 5	No
U.S. Steel	18	23	+ 28	+ 5	No	13	15	+15	+ 2	No
Efforts to control water pollution:										
Republic Steel	17	40	+135	+23	Yes	19	36	+89	+17	Yes
J&L	13	20	+ 54	+ 7	Yes	15	12	−20	− 3	No
U.S. Steel	13	22	+ 69	+ 9	Yes	15	15	0	0	No
Concern for Cleveland's environment:										
Republic Steel	21	46	+119	+25	Yes	15	29	+93	+14	Yes
J&L	19	28	+ 47	+ 9	Yes	16	16	0	0	No
U.S. Steel	17	26	+ 53	+ 9	Yes	14	15	+ 7	+ 1	No
Overall support of the community:										
Republic Steel	25	54	+116	+29	Yes	18	33	+83	+15	Yes
J&L	23	27	+ 17	+ 4	No	15	17	+13	+ 2	No
U.S. Steel	22	29	+ 32	+ 7	Yes	13	18	+38	+ 5	No
(Base)	(400)	(400)				(200)	(200)			

* Combination of 5 and 4 ratings in a 1 to 5 rating scale.

table 4A

Question: *Overall, what is your impression of Republic Steel?*

Without aid, respondents perceive Republic Steel as providing jobs (22 percent in Cleveland, 26 percent in fence-line), having a good reputation (18 percent in Cleveland, 25 percent in fence-line), and trying to stop pollution (18 percent in Cleveland, 25 percent in fence-line).

Impression of Republic Steel	City of Cleveland					Fence-line				
	May	*November*	*Percent change*	*Point change*	*Signi-ficant*	*May*	*November*	*Percent change*	*Point change*	*Signi-ficant*
Positive response:										
They provide jobs/hire people	20%	22%	+ 10	+ 2	No	27%	26%	− 4	− 1	No
They have a good reputation/ a good company	17	18	+ 6	+ 1	No	23	25	+ 9	+ 2	No
They are environmentally concerned/ are trying to stop pollution	8	18	+125	+10	Yes	4	25	+525	+21	Yes
They are a large company	8	8	0	0	No	13	10	− 23	− 3	No
They are good for Cleveland	8	14	+ 75	+ 6	Yes	8	14	+ 75	+ 6	No
Negative response:										
They pollute the air/do not control pollution	12	9	− 25	− 3	No	17	15	− 12	− 2	No
Base	(400)	(400)				(200)	(200)			

Note: Only comments with 10 percent or more mentions listed.

table 4B

Question: *Do you feel it is good for Cleveland to have Republic Steel in the community? Why do you say that?*

Ninety-five percent (95 percent) of the respondents said, yes it is good for Cleveland to have Republic Steel in the community. The major reason cited was that Republic provides jobs for Cleveland.

Reactions to Republic Steel being located in Cleveland

	City of Cleveland					*Fence-line*				
	May	*November*	*Percent change*	*Point change*	*Signi-ficant*	*May*	*November*	*Percent change*	*Point change*	*Signi-ficant*
Do you feel it is good for Cleveland to have Republic Steel in the community?										
Yes	93%	95%	+ 2	+ 2	No	91%	96%	+ 5	+ 5	No
No	5	2	− 60	− 3	No	8	4	− 50	− 4	No
Yes reasons:										
They provide jobs for Cleveland	81	80	− 1	− 1	No	77	88	+ 14	+11	Yes
Cleveland needs companies like Republic	11	17	+ 55	+ 6	Yes	9	14	+ 56	+ 5	No
They help Cleveland by paying taxes	10	7	− 30	− 3	No	2	5	+150	+ 3	No
They are good for the image of Cleveland/Cleveland needs them	10	6	− 40	− 4	No	14	13	− 7	− 1	No
They are good for Cleveland's economy	6	16	+167	+10	Yes	22	18	− 18	− 4	No

table 5

Question: *What particular industry do you think of as the major cause of air/water pollution? What specific companies do you consider as major causes of air/water pollution?*

Perceptions of the steel industry in general, and Republic Steel in particular, as causes of water pollution increased in the fence-line. Unaided mentions of Republic as a cause of water pollution went from 9 to 24 percent, a 167 percent increase.

Causes of air/water pollution

	City of Cleveland					Fence-line				
	May	*November*	*Percent change*	*Point change*	*Significant*	*May*	*November*	*Percent change*	*Point change*	*Significant*
Industry causing:										
Air pollution:										
Steel mills	61%	58%	− 5	−3	No	70%	74%	+ 6	+ 4	No
Automobile industry	8	8	0	0	No	1	7	+600	+ 6	No
Factories	4	12	+200	+8	Yes	3	3	0	0	No
Water pollution:										
Steel mills	21	26	+ 24	+5	No	15	39	+160	+24	Yes
Chemical plants	10	12	+ 20	+2	No	19	9	− 53	−10	Yes
Factories	2	11	+450	+9	Yes	8	11	+ 38	+ 3	No
Company causing:										
Air pollution:										
Republic Steel	33	27	− 18	−6	Yes	42	49	+ 17	+ 7	No
J&L	18	15	− 17	−3	No	28	33	+ 18	+ 5	No
Ford	7	5	− 29	−2	No	1	5	+400	+ 4	No
All steel companies	3	6	+100	+3	No	6	4	− 33	− 2	No
Water pollution:										
Republic Steel	9	10	+ 11	+1	No	9	24	+167	+15	Yes
J&L	5	9	+ 80	+4	No	7	16	+129	+ 9	Yes
Harshaw Chemical	2	2	0	0	No	4	4	0	0	No
Base	(400)	(400)				(200)	(200)			

section B

Strategic external environment

case 5

Modern Office Supply, Inc.

1 In July 1954, two experienced retail managers in their early 30s pooled their resources and purchased Greentree Stationery and Supply, Inc. This retail firm was a specialty-type store carrying high-quality lines of office supplies. The store was located on the main street in the downtown shopping area of Greentree, Ohio, an industrial community of 40,000 people located 20 miles east of Columbus.

2 Under its previous owner, the company had enjoyed 23 years of successful growth and profitability. Although it was small for its type, the company was financially sound and was well established as a reputable business.

3 Immediately after the purchase, the new owner-managers, Martin Hersh and Paul Dixon, ceased operations for a 10-week period in order to renovate and redecorate the store. Then, on January 10, 1955, under the new name of Modern Office Supply, Inc., the firm reopened to the public.

4 In its abbreviated first year of operations, Modern Office Supply had a sales volume of \$37,080, a decrease of \$5,315 from the previous year. This downturn was quickly reversed, however, and in the next 18 years of operation, the firm never again suffered a decrease in sales, as is shown in Exhibit 1.

5 The growth of the business necessitated an increase in inventory storage space and a larger sales area. Thus, in 1967, Modern Office Supply relocated

This case was prepared by John A. Pearce II of the University of South Carolina.

exhibit 1
Sales and income figures, 1955-1973

Year	*Sales volume**	*Percentage change for the year*	*Taxable income*
1955	$ 37,080	−13	−$ 1,820
1956	55,620	50	1,670
1957	63,960	15	2,620
1958	71,680	12	3,010
1959	81,730	14	3,100
1960	90,730	11	2,990
1961	98,890	9	2,570
1962	107,800	9	3,450
1963	115,340	7	2,650
1964	129,200	12	5,680
1965	143,410	11	6,450
1966	159,180	11	5,570
1967	173,510	9	5,380
1968	194,330	12	10,300
1969	221,530	14	10,850
1970	243,700	10	8,530
1971	265,620	9	6,910
1972	281,160	6	5,340
1973	287,190	2	1,730

* All figures have been rounded.

across the street in a newly remodeled building which offered double the square footage of their first store. The new store provided 11,000 square feet of shopping space on two levels and an equal amount of inventory space.

6 There was also a steady need for additional employees. By 1972 the managers were supervising 12 full-time salesclerks. All the clerks were women, although men were also actively sought when positions were available. Ten of the 12 were married, and in 1973 they averaged 45.2 years of age, with a range of 32 to 62 years. Modern Office Supply also regularly employed four high-school students on a part-time basis to perform stockroom, janitorial, and delivery duties.

7 That Modern Office Supply had experienced an exceptionally low turnover rate throughout its history is shown by the fact that in 1973 seven full-time employees had been with the firm for over 10 years. To a large degree, the appeal of the company as an employer was due to a fringe benefit program which was far superior to those offered by other local businesses. The Modern Office Supply plan included the following features:

1. Six paid holidays were given to all full-time employees.[1]
2. A Christmas bonus of $10 for every year of full-time employment and $5

[1] Holiday pay was calculated by dividing the average work week by five and then multiplying this number by the individual's hourly wage rate.

for every year of part-time employment was paid on an individual basis to employees at the annual company-sponsored Christmas party.

3. Five paid but noncumulative sick days were available to full-time employees each year.
4. Paid vacations were given to full-time employees according to the following schedule: one week after one year, two weeks after five years, and three weeks after 10 years or more with the firm.

8 In addition to the attractive benefit program, Modern Office Supply paid a wage which was competitive for the industry and the locale. Further, merit raises, based on the employee's individual performance, were awarded annually to deserving full-time saleswomen.[2] The hourly wages were also updated each year by an automatic raise of 2 cents. This minimum adjustment was seen by the managers as a protection for the employees against either economic inflation or unfair bias affecting the individual manager's decision on merit raises. Exhibit 2 illlustrates the effect of raises on the wage payroll for the full- and part-time sales personnel as of December 1973.

9 Throughout Modern Office Supply's history, the management philosophy had been to maintain an image as merchandisers of high-quality products. This philosophy was an important factor in the rapid growth of Modern

exhibit 2
Current wage structure

Employee	*Date hired*	*Years of employment*	*Base rate*	*Accumulated automatic raises (2¢/yr.)*	*Accumulated merit raises*	*Hourly rate before May 1, 1974*
Full time*						
Gardner	01/09/55	19	$1.60	38¢	40¢	$2.38
Ulrich	04/09/58	16	1.60	32	22	2.14
Mockin	07/07/59	15	1.60	30	20	2.10
Gould	02/10/60	14	1.60	28	20	2.08
Butler	04/05/63	11	1.60	22	15	1.97
Bliss	05/20/63	11	1.60	22	12	1.94
Schoaf	07/14/63	11	1.60	22	12	1.94
Meyers	01/04/65	9	1.60	18	18	1.96
Liston	02/18/66	8	1.60	16	8	1.84
Freeman	03/15/68	6	1.60	12	8	1.77
Cline	03/15/68	6	1.60	12	5	1.77
Alloway	09/01/69	5	1.60	10	5	1.75
Part time†						
Fenton	10/22/69	5	1.36			1.61
Barbour	04/30/70	4	1.36			1.56
Kyle	09/01/70	4	1.36			1.56
Hinning	05/02/72	2	1.36			1.46

* Thirty hours a week or more.
† Less than 30 hours a week.

[2] *Full-time* was defined as 30 hours a week even though the average workweek of full-time employees had always exceeded this number of hours.

Office Supply, primarily because sales to industrial firms in the area, which constituted approximately 30 percent of the company's business, were mainly of high-quality materials and equipment. In late 1971, however, a change in the industrial segment's purchasing behavior became evident, as an increasing inflationary trend and predicted recession in the economy caused business firms to begin cutting back on expenses. Companies were foregoing the purchase of new, expensive, high-quality equipment and materials and tended toward the purchase of medium-quality items. However, due to inventory and space limitations, and the management philosophy of offering quality products at a moderate price, Modern Office Supply chose not to compete on medium-quality lines. Perhaps as a result, the company experienced a leveling off in its yearly sales volume in 1972.

Recent difficulties

10 In 1973 Modern Office Supply was confronted with a difficult situation. The firm's yearly sales had bettered those of the previous 12 months by a scant 2 percent, with sales in the industrial market most adversely affected. Area businesses had initiated harsh expense-cutting policies, and many had shifted a significant percentage of their purchases to low-priced, low-quality items, such as those carried by discount and department stores. The problem was amplified by the opening of a shopping mall in a location three miles from the Modern Office Supply facility. In addition to 23 other stores, this new shopping center housed a Murphy Mary, a Sears department store, and a locally owned and operated Cut-Rite outlet. These three stores in particular posed competitive challenges to Modern Office Supply sales in both the consumer and business markets. Items such as typewriters, office furniture, paper, and writing instruments could be purchased at a somewhat lower price from the mall stores, and thus they increasingly appealed to budget-constrained purchasers in spite of the fact that the apparent quality of these items was inferior.

11 The demand of furniture customers for the interior design service offered by Modern Office Supply dropped precipitously. Consumers considered this service expendable since, to the degree it was needed, this service could be performed by the purchaser. By so doing, the consumer saved the cost of the interior decorator and was spared any feeling of obligation to buy the high-priced furniture supplied by Modern Office Supply.

12 Faced with these conditions, Hersh and Dixon found it essential to cut back on their own expenses. This objective was accomplished by reducing the store's weekly hours. After a thorough analysis of the store's sales patterns, the managers decided to eliminate Modern Office Supply's Thursday night store hours from 5 P.M. to 9 P.M.[3] The reason for this step was

[3] The remaining business hours were Monday and Friday from 9 A.M. to 5 P.M., Monday night from 5 P.M. to 9 P.M., and Saturday from 9 A.M. to 12 noon. With the exception of the Thursday night hours, these remaining hours were identical to those kept by the majority of retail stores located in downtown Greentree.

twofold. First, it cut back on various operating overhead expenses. Second, it reduced the weekly hourly payroll by 36 hours, since nine full-time clerks were kept on the floor during these four evening business hours. Consequently, the average full time week was reduced from 37.5 hours to 34.5 hours.

13 The new minimum wage law of 1974 presented Hersh and Dixon with an additional dilemma. This legislation had the effect of offsetting the decrease in expenses achieved by the reduction in store hours. The law required companies the size of Modern Office Supply to increase their minimum wage in progressive steps from the current level of $1.60 an hour to $2.30 an hour by 1977. Workers were to begin earning $1.90 an hour on May 1, 1974, $2.00 an hour on January 1, 1975, $2.20 an hour on January 1, 1976, and $2.30 an hour on January 1, 1977. The effect of these hourly wage changes is shown in Exhibit 3.[4]

14 The owners of Modern Office Supply saw this new law as potentially devastating to their profitable operations. The recent economic downturn, coupled with new competition from the mall stores, had caused such a significant decrease in the firm's sales volume that Hersh and Dixon had recently been finding it difficult to justify objectively even the current hourly payroll. Since the new wage legislation would force the amount of the payroll to rise if the total employee hours remained unchanged, the managers decided that they would have to reduce the payroll hours in order to

exhibit 3
Planned wages

Employee	*1974 ($1.90 base)*	*1975 ($2.00 base)*	*1976 ($2.20 base)*	*1977 ($2.30 base)*
Full time				
Gardner	$2.68	$2.78	$2.98	$3.08
Ulrich	2.44	2.54	2.74	2.84
Mockin	2.40	2.50	2.70	2.80
Gould	2.38	2.48	2.68	2.78
Butler	2.27	2.37	2.57	2.67
Bliss	2.24	2.34	2.54	2.64
Schoaf	2.24	2.34	2.54	2.64
Meyers	2.26	2.36	2.56	2.66
Liston	2.14	2.24	2.44	2.54
Freeman	2.09	2.17	2.37	2.47
Cline	2.07	2.17	2.37	2.47
Alloway	2.05	2.15	2.35	2.45
Part time				
Fenton	1.92	2.05	2.27	2.41
Barbour	1.87	2.00	2.22	2.36
Kyle	1.87	2.00	2.22	2.36
Hinning	1.77	1.90	2.12	2.26

[4] The reported profit figures of Modern Office Supply, Inc. (Exhibit 1) are misleading due to the impact of a bonus system which was designed to keep the firm's yearly taxable income below $25,000. Under this plan, both Hersh and Dixon received a yearly bonus of 25 percent of the company's pretax income.

stabilize the payroll. However, rather than cut back on individual weekly hours, the managers decided to lay off the full-time employees with the least seniority. They reasoned that it was better to provide 11 workers with the opportunity to earn a respectable income than it was to place 12 full-time employees at an income level approaching unemployment compensation.

15 Although this approach was not appealing, no other viable alternatives seemed available under the prevailing conditions. Before this action was initiated, however, several employees approached the managers with a proposal to avoid the layoff of their co-worker. The clerks had held a private meeting at which they had unanimously agreed to take whatever cuts were necessary in their individual weekly hours in order to maintain the present sales force. The managers were pleased and readily accepted the proposal, for it allowed them to achieve their goal of reduced payroll hours while also enabling them to retain a valued saleswoman.

16 One major issue still required resolution. The minimum wage legislation mandated a rate of pay substantially greater than that which would normally be paid at Modern Office Supply. When the new wage adjustments were added to the fringe benefit program currently offered by the firm, the payment to employees in real dollar terms far exceeded both the individual and local averages and the level which Hersh and Dixon felt was reasonable. Therefore, the managers decided to try to offset the future wage increases in other areas of the employees' total compensation package. This goal was achieved through modifications of the fringe benefit program which were made effective April 29, 1974:

1. The Christmas bonus plan was eliminated for all employees.
2. The number of paid holidays was reduced to three; namely, Christmas, Thanksgiving, and New Year's Day.

Two further changes pertained only to the fringes provided for employees hired after April 29, 1974:

3. The sick pay allowance was discontinued.
4. Paid vacations were given to full-time employees according to the following schedule: one week after one year and two weeks after five or more years with the firm.

Although these four modifications substantially decreased the worth of fringe benefits, the managers believed the benefits had only been reduced to the level that was considered average for local retail stores.

17 The more difficult problem, however, from the perspective of the Modern Office Supply managers, was the proper means by which to administer the new wage legislation. A quick analysis of the net changes in the employees' compensation package for 1974 disclosed that if the present workweek remained the same, and the hourly rates for all full-time employees were raised by 30-cent increments, the net change in the employee payroll would result

in an increase of \$5,619.08 (11 percent) over 1973.[5] Again, excluding the traditional merit and automatic raises, these same calculations extrapolated to 1977 showed an expected \$16,869.43 increase in the yearly payroll. This amount constituted a percentage increase of 33 percent over 1973.

18 A careful study of their firm's financial statements, shown in Exhibits 4 and 5, convinced Hersh and Dixon that the net dollar impact of the new wage

exhibit 4

Income Statement
For the Year Ended December 31, 1973

Net sales	\$287,190
Cost of goods sold	159,100
Gross margin on sales	128,090
Managers' salaries	50,000
Depreciation	3,250
Other general/administrative expenses	70,140
Operating income	4,700
Interest expenses	1,240
Income before bonus and taxes	3,460
Managers' bonus	1,730
Taxable income	\$ 1,730

exhibit 5

MODERN OFFICE SUPPLY, INC.
Statement of Financial Position
As of December 31, 1973

Assets		
Current assets:		
Cash	\$10,101.06	
Accounts receivable	18,231.42	
Inventories	48,058.04	
Fixed assets:		
Equipment	11,338.94	
Total assets		\$87,729.46
Liabilities		
Current liabilities:		
Accounts payable/trade	\$ 5,724.05	
Other current debt	2,948.73	
Long-term debt:		
Long-term bank loans	12,092.18	
Total liabilities		\$20,764.96
Stockholders' equity		
Capital stock	\$32,500.00	
Retained earnings	34,464.50	
Total stockholders' equity		66,964.50
Total liabilities and stockholders' equity		\$87,729.46

[5] The new wage law was in effect for only eight months (34 weeks) of 1974.

legislation must be further blunted. In formulating their strategy to accomplish this objective, the managers stressed consideration of five key elements of the total compensation package: (1) the fringe benefit program, (2) the minimum wage law changes in the hourly base, (3) the automatic yearly 2-cent an hour raise, (4) the annual merit wage adjustments, and (5) the current status of several employees who were paid substantially above the minimum wage as a result of length of service.

19 The fringe benefit program, which was about to be severely cut, and the wage law changes were considered unalterable. However, Hersh and Dixon believed that, in effect, the new wage law required them to increase Modern Office Supply's annual 2-cent an hour automatic raises by a total of 62 cents an hour over the next four years. Thus, they decided to eliminate the traditional automatic raises.

20 The issue of whether or not to continue the policy of annual merit wage adjustments posed a more difficult dilemma. The managers thought that because of the required increases in the wage base, any merit raises would be unaffordable. On the other hand, the perceived motivational benefits of the merit system would be lost if the plan were discontinued.

21 Closely related to the merit wage issue was the case of several senior employees who might be considered overpaid as a result of their long years of service. Although the $1.90 figure was intended by law as the lowest amount to be paid to clerks, it could also be viewed as the level at which clerks were to be paid. Because of this provision of the law, the Modern Office Supply owner-managers were compelled to increase the hourly rate of the four full-time employees who were paid less than $1.90 an hour. This strategy would greatly reduce the financial burden of the minimum wage legislation. However, the managers feared that such action might eliminate much of the motivational impact of previous merit and automatic raises. In addition, the higher hourly rates of the senior salesclerks often reflected their greater-than-average contributions to the operation of the firm. Senior clerks were often given responsibilities far in excess of those assigned to new, less experienced personnel. Therefore, their overpayment really represented fair compensation for services rendered. Thus, by narrowing the wage gap between the higher and lower paid employees, the mangers believed that they would be taking the risk of alienating clerks who performed special functions for the organization.

22 Having carefully considered several different alternatives, the managers decided that in the years 1974 through 1977, the amount of the legislatively mandated wage base increases would be added to all full-time employees' rates across the board. Essentially then, in 1974, all full-time employees received a 30 cents an hour wage increase. In 1975 their wages were to be increased by 10 cents, in 1976 by 20 cents, and in 1977 by 10 cents. Part-time workers also received upward adjustments based on the governmentally legislated minimum of 85 percent of the base pay of full-time employees.

Thus, in 1974, part-time employees' minimum wage jumped from $1.36 to $1.62 an hour, while their average workweek remained at 25.5 hours.

23 On the morning of April 29, 1974, at a weekly Monday morning sales meeting, both full-time and part-time employees were informed of general changes in the company's wage-compensation program. That afternoon copies of a carefully prepared announcement letter (Exhibit 6) were mailed to each of Modern Office Supply's 16 sales personnel, detailing how their wages, in specific, would be affected by the minimum wage law and the changes in the firm's fringe benefit program.

exhibit 6

MODERN OFFICE SUPPLY, INC.

Dear

Recently President Nixon signed into a law a bill raising the minimum wage for workers in our size business in stages from $1.60 an hour to $2.30 an hour by 1977.

The wage scale provides that the workers in our category are to begin earning $1.90 an hour on May 1, $2.00 in January 1975, $2.20 in January 1976, and $2.30 in January 1977.

It also provides that not more than four students may be employed at 85 percent of the regular full-time rate.

We are in agreement with this law as a protection of workers. Unfortunately it has not been designed to take into consideration the side benefits of any job, and therefore we now find it necessary to convert some of the company programs into "direct-pay" dollars which you are assured of receiving pay by pay.

For new employees hired *after* May 1, 1974, paid vacation earned after one full year of full-time employment will be one week until five years full-time employment, when paid vacation will be two weeks annually thereafter. *Present employees are not affected.*

Our company sick-pay policy will remain in force until attainment of 65th birthday for full-time employees hired *prior* to May 1, 1974. For persons hired *after* May 1, 1974, sick-pay benefits will go into effect on the anniversary of five years' employment.

The following will be paid holidays effective May 1, 1974: New Year's Day, Thanksgiving, and Christmas.

Although the monetary Christmas gift has been a happy tradition for many years, with the newly imposed hourly direct-pay regulations, this tradition must, regretfully, be discontinued.

On Monday, April 29, 1974, your hourly rate has been increased by $______ to $______ per hour and is $______ above the $1.90 wage law.

We have always tried to offer better than average hourly rates to our experienced employees and hope you will be pleased with this arrangement.

Sincerely,

Martin Hersh, Paul Dixon

case 6

Pennsylvania Movie Theatres, Inc.

The corporate perspective

1 Pennsylvania Movie Theatres, Inc. (PMT) is an organization of largely autonomous and previously independent theatres located throughout Pennsylvania. Several years ago, 28 manager-owners of privately held operations exchanged their theatre ownership for PMT stock and the right to continue as theatre managers with the newly formed corporation. At their first annual meeting, the managers voted to select a five-member board of directors from their ranks to coordinate theatre operations and to oversee all corporate activities. Further, they determined that one new director would be elected each year to fill a scheduled vacancy. Each director would serve in a part-time capacity for a four-year term at $3,000 per year.

2 The PMT managers believe that as a corporation they have better opportunities and capabilities than were available to them when they owned their theatres separately. Because of their system of cooperative exchange, they are better able to minimize film rental and advertising costs. They can also offer better opportunities for advancement to their assistant managers. Additionally, the corporate form enables the managers to provide support to weaker member theatres because of their collective managerial experience and collective financial strength. Taking a long-term perspective, the managers believe that this consolidation arrangement will result in more profitable operation for all theatres.

3 The PMT managers wish to offer their communities a safe, inexpensive, and pleasurable leisure-time activity. By satisfying these and other societal needs, they believe that they can achieve their basic corporate objectives of survival and profitability. Among other pertinent societal needs, the managers see the desire for:

1. A safe, inexpensive form of entertainment.
2. A wholesome, imaginative, and stimulating children's diversion.
3. A forum for social debate.
4. An opportunity for family activity.
5. A source for employment of local manpower.
6. An escape from demanding realities.
7. An opportunity for educational and cultural enhancement.

4 Because of their concern for satisfying these needs, the managers choose their films carefully, attempting to offer high-quality movies at the peak of

This case was prepared by John A. Pearce II of the University of South Carolina.

their popularity. They are also concerned with appealing to an audience which includes people of all ages and descriptions. The managers see the corporation as a group of family theatres, so they want to ensure that, with few exceptions, a family unit can attend any show at a PMT theatre without totally sacrificing the enjoyment of any single member. Since their incorporation, PMT theatres have therefore restricted their film offerings primarily to those movies rated G (general audience), PG (parental guidance suggested), and R (restricted to persons over 18). With rare exceptions, X-rated, but never hard pornographic, films have been shown.

5 The managers also want to ensure that the family can enjoy a movie in pleasant surroundings. They attempt to maintain a future-oriented perspective in supervising the daily operations of the theatres as well as when selecting films to be shown. Theatre facilities are periodically renovated, and employees are well trained. All of these efforts are expended in order to provide the most comfortable of theatre experiences and to ensure continued audience patronage.

6 PMT gauges its corporate performance in a number of different ways, among which are ticket sales by type, show time, and movie rating; quarterly revenues; and quarterly profits. Last year, PMT's seventh in operation, the net profits of the PMT theatres dropped almost 7 percent from the year before, even though during the same period, the theatre industry at large had reached all-time, high-profit levels. Two years ago, the return on investment achieved by PMT had been 11.7 percent, while the industry average was 11.3 percent. Last year, the return on investment for PMT was down to 10.1 percent, while the industry average climbed to 11.8 percent. The industry average return on investment for the past five years was 10.9 percent.

7 In reviewing the performance of individual films shown during the past year, the PMT directors found that the few X-rated films they had offered far and away resulted in the greatest profit per film, followed by those rated R. They also noted that on dates when their competitors had shown pornographic-type films, they had appeared to outdraw PMT theatres. Further, since adult ticket sales are the most profitable, the loss of these customers probably represented an associated loss in net income.

An alternative

8 A major film distributor recently approached the PMT directors with an offer to supply them with a selection of good-quality X-rated and pornographic-type films for the minimum contract period of 12 months. If ordered, these films would constitute approximately one third of the movies shown at any single theatre during the year, with the remaining two thirds being supplied by the corporation's present distributor.

9 While a revised movie offering would not require any major technological changes for PMT (e.g., the present projection screens and sound system would be adequate), there is a potentially strong psychological impact upon both the PMT employees and their audiences.

10 Thus, the directors realize that a large and varied set of factors needs to be taken into consideration prior to any contractual commitment to the second distributor.

11 One such factor is the possible consequence of a bill currently before the Pennsylvania state legislature which would ban the showing of pornographic films within the state. Although the bill is being hotly debated, it is given only a 10 percent chance of being passed. The directors are also watching the upcoming gubernatorial election in the state with particular interest. One of the declared candidates is running as a morality candidate, and a major plank in his platform is the banning of all X-rated films in Pennsylvania theatres. While he is given only a 5 percent chance of being elected, the news media have given great attention to the morality issues raised by this candidate, as they have to the pending legislation.

12 On the other hand, the directors perceive a widespread belief among the general population that sexual explicitness in any medium has some value. They also sense growing support for the individual's right to decide for himself what does or does not possess redeeming social value.

13 Another factor which the directors have considered is that as the nation's affluence increases, so does its leisure time and its demand for leisure-time activities such as movie theatre entertainment. They are uncertain, however, about the effects which current economic conditions will have upon their operations. They expect an economic recession but are unsure whether the accompanying period of tight money will bring more people to the theatre in lieu of more expensive forms of entertainment or, alternatively, whether all entertainment businesses will suffer.

14 Another consideration affecting the directors' decision is the fact that the majority of PMT theatres are in small- to medium-sized towns with an average population of 23,569 people. All of the theatres are located in downtown business districts, and all theatre fronts open onto main shopping streets. In nearly every case, however, the PMT theatres have a competitor within two city blocks. These facts concern the directors, since they believe that trends toward liberalism are relatively slow to develop in small towns and that any failure on their part would be to the immediate advantage of their competitors.

15 The possible impact upon price policies and theatre hours is also being considered. The average for an adult movie ticket at a PMT theatre in the past year was $2.675, while the average for PMT competitors was estimated at $2.83. Should the second contract be approved, PMT estimates that its average could rise to $2.77, reflecting the corporation's ability to increase its rates for the X-rated movie audiences.

16 Although show hours vary slightly among PMT theatres, the pattern for weekdays includes a matinee at 2 P.M. and two evening shows at 7:30 P.M. and 9:30 P.M. On weekends, a late-afternoon performance at 5:30 P.M. is added. On Saturdays, the matinee is often reserved for the showing of children's films which are scheduled by the individual managers especially for this purpose. Although these films contribute no profit to the corporation—

because of their low ticket prices—the managers feel that this policy develops goodwill between the theatre and the community. No change in these theatre hours is anticipated by the directors in the event that the second supplier contract is signed.

17 In addition to price policies (selective rate increases needed) and to theatre hours (no changes required), the directors have considered the possible effects of showing X-rated films on other facets of the theatres' operations, for example, media advertising and in-theatre promotion.

18 PMT theatres currently advertise through the radio and newspaper media. Whether or not the new contract with the supplier of the X-rated films is signed, these two media will continue to be used, with the expectation that neither costs nor potential audiences will change significantly.

19 However, if the contract is signed, some changes with in-house promotion will probably be necessary. One possible plan is that the audiences of G-, PG-, and R-rated movies will be exposed only to previews and billboards advertising similarly rated movies. The exception will be in the case of viewers of X-rated movies, who will be shown in-theatre promotions on any upcoming films, regardless of their ratings.

20 Concession stand operations are not expected to be affected, since on previous occasions when X-rated movies were shown, managers did not notice any changes in concession volume or item preference. The directors believe that the concession stand will continue to yield approximately 53 cents (gross) per customer regardless of the movie being shown.

21 PMT's distribution channels should be unaffected in the event that a contract with the second film supplier is approved. No additional distribution costs are expected, therefore, but some inventory control changes would be necessary. The main change would be that the two brands of film would need to be kept separate in the film depository, which would be possible through the initiation of a second numerical filing system. The PMT managers recognize the difficulties commonly associated with such a new system but feel that the required adjustments could be quickly overcome.

22 No attempt has yet been made to determine how nonmanagerial PMT employees would feel about an increase in the number of X-rated films being shown in their theatres. Of central concern is the impact which the change might have upon the employees' interest in union membership. To management's knowledge, no attempt has ever been made by its employees to bring in a union. The directors attribute this favorable situation to its employee relations effort and to the high turnover rate among its teen-age employees. To date, there has been only one incident, involving a 55-year-old female street booth ticket clerk who objected to "dirty films," to indicate that the employees might react negatively to any increase in X-rated offerings.

Consolidated projections

23 After conducting the broad-based assessment of the impact that offering X-rated and pornographic films might have upon PMT's profits, the direc-

tors reached the following projection for three years from now, assuming that the second contract is signed:

Likelihood of reaching or exceeding industry average	30%
Likelihood of equaling their own performance of last year	30
Likelihood of a 10 percent decrease in the PMT return on investment from the previous year	20
Likelihood of a 20 percent (or greater) decrease in the PMT return on investment from the previous year	20

24 Overall, the directors foresee an opportunity to increase business by attracting a new segment of moviegoers. Additionally, the prospective new supplier argues that regular adult PMT customers will attend the theatre more often. Thus, the directors believe that a revised film offering could enable them to better meet the interests of an enlarged segment of the population and that, in return, these customers would help ensure PMT's long-term survival.

25 Should they contract with the second supplier, the directors plan to monitor the corporate performance carefully. Among their targets would be the following:

1. Adult ticket sales per movie for all but X-rated films should remain stable or increase slightly.
2. Children's ticket sales should remain stable or increase slightly.
3. Adult ticket sales per movie on X-rated films should exceed adult ticket sales per movie for films of any other rating.
4. Quarterly profits, adjusted for seasonal variations, should reflect an upward trend.

In the event that any of these targets is not being met, it would signal a need to reassess the wisdom of the revised film offering.

26 Although the PMT directors have the responsibility of proposing corporate strategy, the success of the strategy rests upon the commitment of the managers in carrying it out. The question arises for the directors as to the extent to which the managers would give the films of the second supplier a real chance. Although, or since, a manager's bonus reflects the degree of profit of his theatre, he may be reluctant to fully implement a new strategy regardless of the directors' judgment. A recent straw vote of managers to the question "Do you favor an increased offering of X-rated and pornographic-type films?" showed 12 in favor, 5 against, and 11 undecided.

27 It appears that the results of the straw vote somewhat parallel the performance of the voting managers' theatres. Managers who were experiencing increasing revenues tended to vote against the second supplier, those

with relatively level sales seemed to be undecided, while those with decreasing or typically low sales favored the proposal. Such voting tendencies might be a reflection of the mangers' bonus system. Each manager/owner received an annual bonus equal to 60 percent of the pretax net income of their individual theatre and a $^1/_{28}$ share of a pool composed of 25 percent of the pretax net income of all theatres.

28 In two months, the annual stockholders' meeting will take place. The managers all anticipate that the main order of business will be a discussion of the directors' proposal regarding a contract with the second distributor.

case 7

Pamida Incorporated

1 Pamida, a Nebraska Corporation, was founded in 1963 by Jim Witherspoon and Lee Wegener. The company started as two small retail outlets located in Knoxville and Oskaloosa, Iowa and has grown to a discount retail organization with net sales of $241 million for the year ending January 31, 1976. With corporate headquarters located in Omaha, Nebraska, Pamida distributes retail merchandise to its Gibson Discount stores located in mid-America. Most of the stores are located in small communities which are agriculturally based. These communities range in population from 8,000 to 12,000. The geographic area served by the organization includes Nebraska, Kansas, Missouri, Illinois, Michigan, Iowa, Wisconsin, Minnesota, North and South Dakota, Wyoming, Montana, and Idaho. (See Exhibit 1.) Jim Witherspoon, chairman of the board and past president, characterizes the company criteria for success as, "involvement of our people in helping create and support the overall company objectives. Through our decentralized management approach we emphasize merchandising, advertising, and people, but we keep in mind that any organization that is well motivated and has an aggressive approach needs ideas, because it is ideas which produce profits, economies, efficiencies, and change."

exhibit 1
Geographic distribution

State	*Number of stores*
Idaho	5
Illinois	18
Iowa	50
Kansas	19
Michigan	1
Minnesota	34
Missouri	15
Montana	3
Nebraska	13
North Dakota	5
South Dakota	10
Wisconsin	9
Wyoming	12
Total	194

This case was prepared by Steve Lawrence under the supervision of Bruce A. Kirchhoff of the University of Nebraska at Omaha.

2 Pamida employs a decentralized management system, with each store operated as a profit center. The store manager is responsible for the operation of his store unit and is compensated by a base salary plus a bonus, calculated on the sales and profits of his individual store.

3 Pamida's Gibson Discount Centers are divided into three regions, with a manager responsible for each region. Under each regional manager are six district managers who are responsible for 10 to 13 stores. In addition, there are 11 field merchandise supervisors who assist the district managers, thereby increasing the time the district managers are able to spend in the stores.

4 Besides the 190 full-time Gibson stores, Pamida operates 12 small stores carrying mainly health and beauty aids. None of these stores are operated under the Gibson name. The company also operates a small rack-jobbing venture which distributes health and beauty aids, soft goods, and automotive supplies. These operations account for 6 to 7 percent of sales and, although profitable, no expansion is planned for either.

5 Pamida is the parent company to its wholly-owned subsidiary Gibson Discount Centers. Pamida buys merchandise and distributes it to Gibson Discount Centers.

6 **Marketing.** Pamida's retail outlets are named Gibson Discount Centers. The right to use this name has been granted by license agreement with H. R. Gibson of Seagoville, Texas, who franchises this name nationally. Pamida pays a relatively small fixed fee for the name which extends to all of the stores presently operated by Pamida. Since the original license agreement was entered into, additional Gibson Discount Centers have been opened by Pamida with the consent of Gibson. However, there is no assurance that this practice will continue. The agreement between Pamida and H. R. Gibson may be terminated by either party on 90 days' written notice. In the agreement, H. R. Gibson retains the right of quality control over any of the products sold by Pamida at any of its Gibson Discount Centers. There are numerous other Gibson lincesses in most of the states in which Pamida operates. Pamida's management believes that termination of the agreement with H. R. Gibson would not have a materially adverse effect on the organization.

7 Pamida's current marketing strategy is to locate Gibson Discount Centers in small, agriculturally oriented communities. In most instances the communities are the county seat. Pamida has found that major retailers have tended not to locate in communities of this size. Thus, the major source of competition for the Gibson Discount Centers are the local drug and variety stores. Most of these communities are too small to support more than one major retail organization. Historically, Pamida's marketing strategy was to locate in towns of between 8,000 and 10,000. When these markets started to become saturated, the company changed its emphasis to include towns between 4,000 and 12,000.

8 Customers may select from between 9,000 and 14,000 nationally advertised brand-name products depending on store size, which ranges from 8,000 to 40,000 square feet. None of the stores sells big-ticket items such as major appliances and furniture. The bulk of store sales dollars is from merchandise with a price of less than $5. A breakdown of the merchandise line (Exhibit 2) includes:

1. Soft lines—primarily clothing items.
2. Health and beauty aids—includes prescription and nonprescription drugs, as well as personal hygiene products.
3. Hardware and appliances—includes basic hardware and small appliances like toasters and blenders.
4. Food, candy, cookies, and tobacco.
5. Automotive—includes supplies and accessories for automobiles, trucks, and tractors.
6. Sporting goods.
7. School and pet supplies.
8. Jewelry, records, and tapes.
9. Housewares.
10. Toys.

It is management's policy to offer merchandise with quick-selling characteristics at competitive prices. Pamida's pricing policy is to price at or below the manufacturer's suggested retail price, thereby meeting or underselling the local competition. The merchandise line includes items which fall into the necessity, rather than luxury, classification. The primary reason for carrying merchandise with quick-selling characteristics is to maximize inventory turnover. Company policy is to maintain a large in-stock condition, since many rural customers travel long distances to shop at the Gibson Discount Center.

9 It is Pamida's policy to emphasize cash and carry sales. Pamida's accounts receivable for rack jobbing generally account for less than 2 percent of sales. Gibson Centers have no accounts receivable. The company does not offer contract purchase plans and accepts bank credit cards at only one

exhibit 2
Pamida 1975 sales by category

Category	*Percent*
Soft goods	22.0%
Health and beauty aids	16.0
Hardware and appliances	14.0
Food, candy, cookies, and tobacco	10.0
Automotive supplies	10.0
Sporting goods	9.0
School, pet supplies, and misc.	6.0
Jewelry, records, tapes, cameras	6.0
Housewares	6.0
Toys	1.0

third of its locations. Stores accepting bank credit cards are those with the larger square footage.

10 Pamida recently adopted a merchandise line expansion policy. Reflecting this new emphasis, the company assumed operation of the women's and children's clothing departments, which had previously been operated by a lessee. Pamida is also putting pharmacies in all stores over 20,000 square feet.

11 **Property management.** Pamida's Real Estate Development and Construction Department handles the purchase of real estate and the plans for construction of store units. Pamida still owns several of its larger stores, but in the past few years has been using the sale-leaseback method of real estate finance. The sale-leaseback technique was initiated to maximize the amount of capital available for expansion. Prior to 1973, Pamida's policy was to construct and own its facilities, or to lease existing structures. Exhibit 3 presents a schedule of property, buildings, and equipment.

exhibit 3

Schedule of assets (year ended January 31, 1976)

Classification	*Balance at beginning of period*	*Additions at cost*	*Retirements or sales*	*Transfers*	*Balance at close of period*
Land and improvements	$ 899,000	$ 574,000	$ 87,000		$ 1,436,000
Buildings and improvements	4,679,000	55,000	—		4,734,000
Furniture and equipment	11,571,000	3,051,000	242,000		14,380,000
Automotive	499,000	163,000	45,000		617,000
Lease-hold (improvements)	914,000	579,000	51,000		1,422,000
	$18,562,000	$4,422,000	$375,000		$22,609,000

12 Once the decision to build a store is made, the search for a buyer is begun. Usually a buyer is found before construction is started, but many times the store will be constructed regardless of the availability of a buyer. The store will then be sold, at a later date, to an individual or group of investors. Pamida has found that rental rates are generally lower than rates charged in large cities. Rent is based on a percent of sales in 13 leases.

13 Building construction lasts about 120 days, and the store can be fully stocked and ready to open 30 days after construction is complete. The parking area is generally three times larger than the store space. The cost of trade fixtures (cash registers, display units, etc.) runs $2.50 per square foot.

14 Management plans call for the addition of approximately 20 stores per year. The company expects to realize this goal through new openings, relocations, and expansions of existing units.

15 The size of relocations is governed by the population and growth trends of the particular town. New openings are governed by the same criteria. The

sites are located primarily in shopping centers, if possible, or near supermarkets as a second alternative.

16 **Advertising.** LeRoy Peterson, director of corporate advertising, states, "The goal of the advertising department is to create sales." As a discount store organization, Pamida stresses prices of merchandise in their ads.

17 Advertising costs run about 2.5 percent of sales. The choice of advertising media depends on the resources available in the local market. However, the major advertising media are local newspapers, which receive about 70 percent of total advertising dollars. Approximately 20 percent of the advertising dollar is spent on direct mailings and shopper publications. The remainder is divided between radio and television time. Between 10 and 15 reprint ads are prepared by corporate advertising each year.

18 Peterson indicates that Pamida's advertising policy allows for flexibility at the individual store level. The company allows the local store management to substitute or make price changes to any advertisement layout sent from Omaha. The reason for this policy is to allow the store managers to adjust for local price competition, inventory shortages, and tastes.

19 **Traffic and warehouse.** To facilitate Pamida's in-stock policy, an ordering system called MSI is used. Under MSI, a record of the rate of sale for all merchandise is maintained in an orderbook. Orders are shipped from the Omaha warehouse 72 hours before the merchandise is expected to arrive at the store. The majority of the merchandise is truck shipped within a 400–500 mile radius of the Omaha warehouse.

20 Approximately 41 percent of total discount store sales consist of merchandise shipped through the Omaha warehouse. Most of the remaining merchandise is shipped directly from the manufacturer to the individual store. The Omaha warehouse has 260,000 square feet and is believed sufficient to serve approximately 250 stores. Pamida also operates a smaller, 40,000-square-foot warehouse in Omaha which is used as a "flow-through" distribution center. The company has purchased a 22-acre tract of unimproved real estate nearby and tentatively plans to replace the 40,000-square-foot structure in the near future.

21 The traffic department is responsible for the physical movement of goods. This includes both inbound and outbound shipments. Deciding the mode of transportation and the timing of the individual shipments, at the lowest possible cost, is the main objective of this department.

22 Inbound shipments to the Omaha warehouse are transported 65 percent by truck, 24 percent by rail, and 10 percent by air freight. Outbound shipments to the individual stores are accomplished through use of Pamida's private fleet of 26 tractors and 80 trailers.

23 Floyd Knutson, director of traffic for Pamida, states: "Since the cost of transportation is set in terms of rate structures, rates cannot be bargained, and the savings must be realized in terms of judgments made by this depart-

ment." Knutson indicates that these judgments fall into several categories. Some of these cost-saving measures include:

1. Shipping with higher volume, making fewer trips.
2. Use of consolidation points to keep half-empty loads from being transported long distances.
3. More intensive use of the Omaha warehouse so that shipments can be made to the stores at a lower cost and quality checks can be made on bulk shipments from the manufacturer to the warehouse.

24 **Personnel management.** "Although Pamida is a large organization," says corporate personnel director Jack Doyle, "we like to think of it as a family organization." He indicates that the underlying philosophy is to give individuals jobs to be accomplished, requisite responsibility for accomplishment, and then step back and let them perform.

25 Jim Witherspoon indicated his gratitude for performance by Pamida employees when he donated $1 million of Pamida stock to the employees' profit sharing plan in 1973. He indicated that the employees had made Pamida what it is today.

26 Company policy in the area of management training is patterned after a combination of formal and on-the-job training. The formal aspects of the training last for three days. The formal training session takes place at corporate headquarters. The process involves a series of meetings between the new store manager and various executives. Meetings include conference sessions with the following executive level managers:

Personnel
Controller
Payroll
Printing
Advertising
Merchandising (hard goods, soft goods, and inventory control)
Traffic
At least one corporate officer

Meetings are also held with management personnel in charge of the following areas:

Warehouse operations
Daily reports
Purchase reports
Interstore transfers
Expense reports
Data processing
Store supplies
Accounts payable
Correspondence

exhibit 4
Criteria for personnel evaluation

MANAGEMENT SUMMARY APPRAISAL

Six Month ☐
Special ☐

Date ____________

NAME ____________ S.S No ____________

POSITION ____________ LOCATION ____________

Date of Hire ____________ Present Salary ____________

Date Last Appraisal ____________ Date Last Increase ____________

	Unsatisfactory	Satisfactory	Noticeably Satisfactory
A. ATTITUDE			
1 Enthusiasm			
2. Willingness to assume responsibility			
3. Attitude on meeting the public and handling customers			

COMMENTS: ____________

B MANAGERIAL QUALITIES			
1 Aggressiveness			
2. Quickness of his thinking and soundness of his judgment			
3 Alertness			

COMMENTS: ____________

This Summary Appraisal is a narative description developed from a detailed analysis of the employee's work

C. PERFORMANCE Results: (What has this individual accomplished in measurable results since his last appraisal.)

	This Year	Last Year
Sales		
Gross		
Payroll		
Controlable Expenses		
Net Profit		

COMMENTS ____________

D PREVIOUS EXPERIENCE WITH OTHER COMPANIES AND JOBS ____________

E. PREVIOUS POSITIONS WITH THIS COMPANY ____________

F. METHODS (How does this person go about getting his job done? How does he organize his work? Where applicable, appraise 1) Ability to handle people, 2) Selection of people, 3) Training job done, 4) Upgrading of organization, and 5) Development of people.)

The objective of this three-day training session is to give the new manager a working orientation to company operations. After this initial three-day training session the new manager is sent to a store location where he or she works with an older, experienced manager and learns on the job.

27 Pamida's management feels that since the company is experiencing good growth, management recruitment is important. Pamida recruits store mana-

exhibit 4 (*concluded*)

Management Summary Appraisal

G. PERSONAL QUALIFICATIONS (List only outstanding qualifications either above or below average)

1 General ____________________

2 Strongest Single Qualification ____________________

3 On what points does this employee need help to overcome his weaknesses ____________________

H POTENTIAL What is the next step ahead for this individual and does he have further potential beyond next step? If so, outline

I ACTION (Recommend action for improvement such as Training, Change of attitude, Change in pay, Encouragement, etc.)

☐ LEAVE ON PRESENT JOB ____________________

☐ Put on Probation ____________ Until what date? ____________

☐ REPLACE ☐ Promote ☐ Demote to ____________ ☐ Transfer to job of same classification

☐ TERMINATE

When should recommended action be taken? ____________________

J CHECK CURRENT STATUS OF THIS INDIVIDUAL

☐ Immediately Promotable
☐ Promotable
☐ Satisfactory (Potentially Promotable)
☐ Satisfactory
☐ New on Job or with Company
☐ Questionable
☐ Unsatisfactory

APPRAISAL MADE BY

Name ____________ Title ____________

Name ____________ Title ____________

The performance and personal qualification sections of this report have been discussed with the employee by

Name ____________ Title ____________ Date ____________

Employee Signature ____________ Date Signed ____________

gers from several sources, primarily from other retail chain organizations.

28 Management evaluation takes place every six months. The process includes all personnel within the organization. The procedure requires a conference between the supervisor and the subordinate. The supervisor evaluates the subordinate using criteria set up by the company (see management summary appraisal, Exhibit 4). Doyle indicates that this process allows for

exhibit 5

PAMIDA INC.
Consolidated Statement of Earnings
Ten-Year Summary, 1967–1976

	*1976**	*1975**	*1974*	*1973*
Net sales	$241,579,000	$202,173,000	$158,124,000	$133,669,027
Cost of goods sold	179,935,000	150,945,000	117,123,000	101,155,192
Gross margin	61,644,000	51,228,000	41,301,000	32,513,835
Expenses:				
Selling	38,303,000	31,105,000	23,425,000	19,039,847
General and administrative	7,027,000	5,655,000	4,252,000	3,497,494
Interest	1,242,000	1,368,000	1,000,000	768,559
Sum of expenses	46,572,000	38,128,000	28,667,000	23,305,900
Earnings before taxes	15,072,000	13,100,000	12,624,000	9,207,935
Taxes on income	7,400,000	6,475,000	6,235,000	4,270,000
Net earnings	$ 7,672,000	$ 6,625,000	$ 6,389,000	$ 4,937,935
Net earnings per common and common equivalent	.83	.73	.70	.54
Average common and common equivalent shares and outstanding	9,265,805	9,134,550	9,149,828	9,145,201

n.a. = not available.
* Changed to LIFO inventory costing.
Notes to consolidated statements:
LIFO inventory costing adopted in 1975.
2-for-1 stock split May 1972—additional shares also issued in 1972.
2-for-1 stock split May 1971.
20-for-1 stock split February 1969.

immediate feedback and open and clear communication on and about the subject of the evaluation.

29 **Future growth.** Pamida's current expansion policy was initiated in 1969 in response to trends in population growth. A second factor was the increased consumer acceptance of the discount store format. Many of Pamida's stores were approaching their selling capacity, and in order to maintain historical growth rate in sales volume, the smaller stores were replaced with larger units. The larger units, in already established markets, provided increased sales volume and helped increase Pamida's share of the local market.

30 Store relocation and expansion within existing markets play in important role in Pamida's overall expansion policy. However, the company continues to search for new markets to be served. The primary criteria for the determination of potential new markets are small mid-American towns with an agri-income base, populations of between 8,000 and 12,000, and no other major retail outlet.

31 **Discount industry.** Discount retailing, in its conceptual form, was designated to supply quality merchandise without charging for unneeded services. Industry growth has been rapid and, according to the latest trade statistics, discount department stores are the largest retailers of general merchandise.

1972	1971	1970	1969	1968	1967
$104,509,099	$79,206,264	$62,561,128	$43,612,917	$28,080,511	$19,592,154
77,959,641	59,121,990	46,768,737	33,079,857	21,877,878	15,570,997
26,549,458	20,084,274	15,792,394	10,533,060	6,202,633	4,021,157
17,433,753	13,062,906	9,881,643	6,643,077	4,379,211	2,903,567
(combined with selling)					
664,804	306,499	179,956	102,417	59,599	36,468
96,058,198	72,491,395	56,830,336	39,825,351	26,316,688	18,511,032
8,450,901	6,714,869	5,730,792	3,787,566	1,763,833	1,081,122
3,785,000	2,992,000	2,700,000	1,800,000	718,451	389,448
$ 4,665,901	$ 3,719,869	$ 3,030,792	$ 1,987,566	$ 1,045,372	$ 691,674
1.07	.88	1.51	1.04	.55	.36
4,336,410	4,225,312	2,012,489	1,915,780 First public offering	n.a.	n.a.

Many problems have combined to render the $31 billion industry only marginally profitable for all but the most strongly positioned companies. About half of industry volume is believed to be concentrated in problem companies.

32 Between the mid-1950s and 1967, industry profits grew rapidly as stores, constructed with adequate parking facilities in growing suburban areas, gained acceptability. However, many chains allowed their merchandise quality to slip, and customer count fell from an average of 39,600 households per store to only 12,000 per store.

33 Early in its history, the industry chose the chain concept of centralized merchandising as a means of holding down costs and promoting rapid expansion. This was combined with emphasis on selling the most popular items. Centralized buying, however, needed to be supplemented by experienced decision making on the local level, and for many discounters this was not the case. When emphasis on fashion items increased and consumption patterns began to change, it became more difficult to find popular items, and profitability suffered.

34 Chain economies of scale were late in developing. Few organizations succeeded in garnering substantial market shares in metropolitan areas where department stores and national chains were strong. Image was the main problem.

exhibit 6

PAMIDA INC.
Consolidated Balance Sheet
Eight-Year Summary, 1969–1976

	*1976**	*1975**	*1974*	*1973*	*1972*	*1971*	*1970*	*1969*
Current assets:								
Cash	$ 3,856,000	$ 1,958,000	$ 3,972,000	$ 2,222,160	$ 744,075	$ 599,077	$ 528,127	$ 303,150
Trade Accounts Receivable (less bad debt allowance)	2,168,000	1,677,000	1,904,000	1,702,713	1,557,659	1,471,891	815,562	536,849
Accounts receivable (other)	574,000	80,000	165,000	7,029,505	0	0	0	0
Merchandise inventory	85,211,000	59,286,000	48,378,000	46,960,419	34,309,393	22,019,966	16,000,556	10,181,865
Prepaid expenses	756,000	794,000	494,000	495,334	277,861	183,628	58,085	15,199
Total current assets	92,565,000	63,795,000	54,913,000	58,410,131	36,888,988	24,274,562	17,402,330	11,037,063
Property, building and equipment	15,378,000	13,125,000	11,859,000	11,068,043	9,918,539	4,765,157	1,984,094	1,198,960
Other assets	1,353,000	1,094,000	1,029,000	570,195	531,256	224,418	181,274	154,740
Total assets	$109,296,000	$78,014,000	$67,801,000	$70,048,369	$47,338,783	$29,264,137	$19,567,698	$12,390,763
Current liabilities:								
Notes payable to bank	$ 7,650,000	$ 5,500,000	$ 1,000,000	$ 7,000,000	$ 5,500,000	$ 3,592,335	$ 664,232	$ 871,822
Trade accounts payable	25,553,000	10,603,000	10,472,000	14,802,346	8,698,104	4,057,183	3,891,109	3,754,304
Salaries and wages	675,000	613,000	463,000	706,769	536,750	419,965	353,103	203,891
Taxes other than Income tax	935,000	821,000	533,000	453,388	493,085	314,208	231,763	154,696
Other accrued expenses	2,019,0.0	1,625,000	1,114,000	942,540	771,718	497,523	338,369	210,094
Taxes on income	368,000	398,000	2,152,000	1,025,560	1,570,318	1,532,443	1,767,224	1,506,158
Current maturities of long-term debt	639,000	565,000	536,000	225,063	227,517	667,996	553,227	187,770
Total current liabilities	37,839,000	20,125,000	16,270,000	25,155,666	17,797,492	11,081,653	7,799,097	6,888,715
Deferred tax on income	100,000							
Long-term debt (less current maturities)	14,027,000	7,471,000	7,988,000	8,053,343	7,898,001	2,094,218	1,578,392	720,331
Compensation deferred	150,000							
Stockholders' equity:	4,567,000	4,567,000	4,567,000	4,565,297	2,140,409	1,057,542	1,009,190	957,890
Additional paid-in capital	12,630,000	12,627,000	12,377,000	12,064,486	4,262,492	4,456,236	2,326,400	—
Retained earnings	39,983,000	33,224,000	26,599,000	20,209,577	15,240,389	10,574,488	6,854,619	3,823,827
Total stockholders' equity	57,180,000	50,418,000	43,543,000	36,839,360	21,643,290	16,088,266	10,190,209	4,781,717
Total liabilities and equity	$109,296,000	$78,014,000	$67,801,000	$70,048,369	$47,338,783	$29,264,137	$19,567,698	$12,390,763

* Changed to LIFO inventory costing.

35 The Kmart division of S. S. Kresge has expanded even more rapidly than the industry since 1962. Yet through careful attention to image building, recognizable values, and fashion business, the company's record of profitability was improved. Today, K mart's dominance of the industry is unquestioned.

36 On a national scale, other former variety store operators, F. W. Woolworth and W. T. Grant, entered the business. But these organizations fell prey to the mistakes of most other discounters, with Grant declaring bankruptcy in early 1976. On the other hand, some smaller regional chains have preserved flexibility in their operations by limiting the geographical dispersion of stores and controlling expansion activities. These organizations have met with success in recent years.

exhibit 7
Consumer price index (1967 = 100)

Year	*Nondurables*
1974	151.0
1973	132.8
1972	121.7
1971	117.7
1970	114.0
1969	108.9
1968	103.1
1966	98.1

Source: U.S. Department of Commerce.

exhibit 8
Total retail sales ($ millions)

Type of retailing	*1970*	*1971*	*1972*	*1973*	*1974*
All retailers	375,876	408,850	448,379	503,317	537,782
Nondurable	261,239	177,036	298,720	333,042	370,469
Durable	114,238	131,814	149,659	170,275	167,313
Department stores	37,295	42,027	46,560	52,292	55,871
Variety stores	6,959	6,972	7,498	8,212	8,714
Drug and proprietary	13,366	13,736	14,523	15,474	16,785

Source: U.S. Department of Commerce.

exhibit 9
Retail sales index—discount stores (1967 = 100)

Company	*1970*	*1971*	*1972*	*1973*	*1974*
Alexander's Inc.	125	138	146	149	151
Ames	226	228	308	337	436
Arlen	—	100	102	106	107
Hecks	189	226	306	397	484
Kings	143	150	165	193	206
Mays	148	154	153	154	151
Pamida	282	383	476	564	720
Vornado	114	119	108	117	128
Wal-Mart	351	618	990	1327	1872
Zayre	164	192	226	241	253

Source: Standard & Poor's.

exhibit 10
Profit margins—discount stores (percent)

Company	*1970*	*1971*	*1972*	*1973*	*1974*
Alexander's Inc.	7.4	6.8	4.0	4.2	3.8
Ames	6.2	6.7	6.5	5.1	5.1
Arlen	—	4.0	3.7	1.6	—
Hecks	7.8	8.6	8.5	8.5	7.9
Kings	8.2	8.3	7.5	7.0	5.6
Mays	6.6	6.3	5.2	4.5	3.7
Pamida	9.4	9.1	8.2	9.5	8.0
Vornado	4.0	4.1	4.1	3.0	2.6
Wal-Mart	7.9	7.9	7.8	8.2	6.3
Zayre	4.5	4.6	4.3	4.2	2.8

Source: Standard & Poor's.

exhibit 11
Net income—discount stores (1967 = 100; $ millions)

Company	*1970*	*1971*	*1972*	*1973*	*1974*
Alexander's Inc.	219	206	57	39	42
Ames	219	297	326	282	314
Arlen	—	100	96	def.	def.
Hecks	248	337	448	544	567
Kings	152	172	178	200	168
Mays	204	235	161	238	89
Pamida	354	444	470	608	631
Vornado	103	115	106	42	23
Wal-Mart	344	606	956	1,283	1,323
Zayre	90	118	125	107	10

def. = deferred.
Source: Standard & Poor's.

exhibit 12
Net income as percent of sales—discount stores

Company	*1970*	*1971*	*1972*	*1973*	*1974*
Alexander's Inc.	2.5	2.1	0.6	0.4	0.4
Ames	3.0	3.5	3.3	2.6	2.2
Arlen	—	1.6	1.5	def.	def.
Hecks	4.2	4.8	4.7	4.4	3.8
Kings	3.9	4.2	4.0	3.8	2.9
Mays	2.4	2.4	1.8	1.5	1.0
Pamida	4.7	4.5	3.7	4.0	3.3
Vornado	1.3	1.5	1.5	0.5	0.3
Wal-Mart	3.7	3.7	3.7	3.7	2.7
Zayre	1.2	1.3	1.1	0.9	0.1

def. = deferred.
Source: Standard & Poor's.

exhibit 13
Price earnings ratios—discount stores

Company	*High/low*	*1970*	*1971*	*1972*	*1973*	*1974*
Alexander's	High	17.0	22.9	—	36.5	26.3
	Low	9.5	13.1	23.0	12.5	6.9
Ames	High	11.0	18.5	25.9	12.9	4.6
	Low	4.9	8.0	9.4	3.6	2.2
Arlen	High	—	31.8	44.2	def.	def.
	Low	—	16.5	19.9	def.	def.
Hecks	High	18.0	29.0	28.0	21.3	9.2
	Low	7.0	14.0	14.0	5.2	7.8
Kings	High	11.5	22.4	20.5	12.0	7.0
	Low	6.8	13.4	10.4	4.3	4.3
Mays	High	13.7	17.8	19.7	12.0	9.3
	Low	6.9	10.3	8.2	5.0	4.5
Pamida	High	24.4	35.6	45.6	35.0	8.9
	Low	12.2	19.6	4.0	6.0	3.6
Vornado	High	10.8	13.7	17.9	25.0	15.5
	Low	4.0	9.5	6.7	4.0	7.3
Wal-Mart	High	22.5	43.6	50.0	38.0	21.6
	Low	13.7	13.0	28.2	13.0	7.8
Zayre	High	26.2	22.9	18.5	16.0	—
	Low	12.3	14.6	11.0	2.0	17.9

def. = deferred.
Source: Standard & Poor's.

exhibit 14
Dividends—discount stores (as a percent of earnings)

Company	*1970*	*1971*	*1972*	*1973*	*1974*
Alexander's	18.9	21.2	78.9	38.5	34.5
Ames	5.9	5.5	7.3	10.8	9.7
Arlen	No dividends declared				
Hecks	8.3	7.1	6.0	6.9	7.2
Kings	23.5	29.2	28.3	27.0	40.3
Mays	27.7	26.8	36.8	45.0	66.7
Pamida	No dividends declared				
Vornado	No dividends declared				
Wal-Mart	—	—	—	5.0	10.5
Zayre	No dividends declared				

Source: Standard & Poor's.

37 To enhance profitability in the future, many companies will be going back to the basics of the business: emphasizing consumable items with fewer fringe items. A move has begun to switch away from centralized merchandising and to greater regionalized decision making.[1]

38 Many discounters have recognized the importance of effective management training and have instituted a restructuring of their management train-

[1] "Profits Squeezed from Many Operators," *1975-Retailing*, Standard & Poor's, p. R-131.

exhibit 15
Capital expenditures—discount stores ($ millions)

Company	*1970*	*1971*	*1972*	*1973*	*1974*
Alexander's	11.68	13.16	12.83	7.38	1.50
Ames	1.32	1.13	1.59	1.81	1.26
Arlen	—	139.91	113.71	232.98	—
Kings	0.52	1.37	1.54	1.37	4.99
Hecks	2.59	1.94	3.89	7.19	2.29
Mays	1.43	3.03	3.52	2.64	6.83
Pamida	3.20	5.86	2.03	2.15	2.88
Vornado	16.65	18.06	29.86	33.35	17.95
Wal-Mart	1.64	4.64	4.66	3.52	6.83
Zayre	25.17	23.95	19.17	15.31	9.02

Source: Standard & Poor's.

exhibit 16
Capital expenditures—discount stores (as a percent of gross plant)

Company	*1970*	*1971*	*1972*	*1973*	*1974*
Alexander's	12.0	12.0	10.8	6.0	1.2
Ames	30.7	21.1	23.0	20.8	12.7
Arlen	—	23.4	17.7	30.0	—
Hecks	18.5	31.1	26.1	17.3	41.0
Kings	15.9	10.8	18.0	25.0	7.4
Mays	7.9	8.4	8.9	6.3	13.9
Pamida	53.3	49.4	48.4	18.1	21.9
Vornado	7.9	8.3	12.9	12.0	6.6
Wal-Mart	44.1	57.3	31.2	20.4	29.4
Zayre	22.5	18.1	13.6	10.2	5.7

Source: Standard & Poor's.

exhibit 17
Spending pattern influences

	1970	*1971*	*1972*	*1973*	*1974*
Population (millions)	204.9	207.0	208.8	210.4	211.9
Persons employed (millions)	78.6	79.1	81.7	84.4	85.9
Percent of population	38.4	38.2	39.1	40.1	40.5
Number of females employed (millions)	29.7	29.9	31.1	32.4	33.4
Percent of population	14.5	14.4	14.9	15.4	15.3
Number over 25 with high school education	60.3	62.4	64.7	67.5	70.4
Percent of population	55.2	56.4	58.2	59.8	61.2
Per capita expenditure on furniture and equipment (millions)	$193	203	233	261	277
Per capita expenditure on clothing and footwear	$258	275	302	334	349

Source: Department of Commerce, Bureau of Labor.

exhibit 18
Operating results of large discount stores (percent of sales exclude leased departments)

	1969	*1970*	*1971*	*1972*	*1973*
Number of firms	43	45	46	47	47
Gross margin	27.99	27.90	28.37	28.11	28.54
Leased department included	2.68	2.64	1.83	1.40	1.09
Gross income	30.67	30.54	30.20	29.51	29.63
Total expense	27.48	28.26	28.08	27.40	27.21
Net operating profit	3.19	2.27	2.12	2.11	2.41
Other including deductions	.27	(−.05)	(−.17)	(−.12)	(−.09)
Earnings before income taxes	3.46	2.22	1.95	1.99	2.32
Taxes	1.67	1.13	1.13	1.28	1.09
Net earnings	1.79	1.09	.82	.71	1.23

Source: Cornell University.

exhibit 19
Discount store population

	1971			*1973*			*1974*		
Region	*A*	*B*	*C*	*A*	*B*	*C*	*A*	*B*	*C*
New England	468	1,942	4.00	523	2,714	4.16	535	2,070	3.87
Midatlantic	856	5,972	6.98	959	6,794	7,08	958	7,015	7.32
East North Central	1,196	5,635	4.71	1,289	6,255	4.85	1,254	6,373	5.08
West North Central	412	1,615	3.92	510	1,942	3.88	527	2,282	4.33
South Atlantic	679	2,965	4.38	816	3,673	4.51	851	3,878	4.56
East South Central	374	1,323	3.54	432	1,405	3.25	471	1,610	3.42
West South Central	612	2,293	3.75	684	2,581	3.77	726	2,681	3.69
Mountain	248	948	3.82	295	1,092	3.70	320	1,301	4.07
Pacific	628	3,847	6.16	633	4,058	6.18	653	4,196	6.43
Total	5,491	26,540		6,162	29,974		6,295	31,426	
Annual average			4.58			4.60			4.75

Key:
A = Number of stores.
B = Volume ($ millions).
C = Per store volume ($ millions).
Source: *Discount Merchandiser*.

ing. Some stores have followed K mart's philosophy by letting the manager have profit control of his store. K mart generally does not let a management trainee have his first store until he has been with the company at least 10 years.

39 One recent trend in the industry is expansion into smaller communities where other retail chains have not located. Smaller stores are constructed in these communities, and the move so far has been profitable.

case 8

The Standard Oil Company (Ohio)

1 It was risky, but the potential for profit made it worthwhile. On January 1, 1970, the Standard Oil Company of Ohio (Sohio) acquired the properties of British Petroleum Oil Corporation (BP). In exchange for the properties of BP, Sohio issued to BP (Overzee) N.V., a wholly owned subsidiary of British Petroleum Company limited, a special stock equivalent to a 25 percent common stock interest in Sohio. The benefits expected to accrue to Sohio as a result of the acquisition were spelled out in Sohio's 1969 annual report. In addition to new oil resources, new markets, and new facilities, Sohio obtained the marketing, refining, transportation, and other oil production interests of Sinclair Oil Corporation (a company which had been acquired by BP).

2 The merger gave Sohio a major interest in the oil-rich North Slope of Alaska. Sohio has a 100 percent working interest in 96,396 acres along the Prudhoe Bay on Alaska's North Slope. As a result of this acquisition, Sohio joined a number of oil producers (Atlantic Richfield, Exxon, Gulf Oil, BP Alaska, and Union Oil) with interests on the North Slope in what has been described as the most complex engineering effort ever undertaken by private enterprise—the trans-Alaska pipeline. In 1978, more than 1.2 million barrels of oil per day were being pumped from North Slope wells and delivered to the U.S. mainland via the pipeline and tankers.

History of the firm

3 On June 10, 1870 with capitalization of $1 million, Henry Flagler, Stephen Harkness, Samuel Andrews, William Rockefeller, and John D. Rockefeller incorporated the Standard Oil Company in Cleveland, Ohio. The name, Standard Oil, was chosen to project standardization of quality and practices in a chaotic industry, and John D. Rockefeller was elected to serve as the company's first president. By 1872, Standard Oil controlled 21 of 26 refineries in Cleveland and all the chief refineries in New York, Philadelphia, and Pittsburgh. During the next three years, Standard Oil's capitalization would increase by $3.5 million to finance acquisitions.

4 From 1880 to 1890, Standard Oil experienced significant changes and innovations which would lead to both profit and heartache. The year 1880 saw the construction of a 102-mile, five-inch pipeline (the first of what would

This case was prepared by Neil H. Snyder of the McIntire School of Commerce of the University of Virginia.

become a network of pipelines cirsscrossing the United States) to transport crude oil from production areas near Titusville, Pennsylvania to Cleveland refineries. In 1882, a trust agreement went into effect with nine trustees holding all the stock of Standard Oil and 40 affiliated companies which, together, comprised 90 percent of refining capacity in the United States. The Standard Oil trust established marketing units in New York and New Jersey, and it continued to expand during the 1880s.

5 The oil industry received a shot in the arm when in 1893 Henry Ford purchased a gallon of Standard Oil's stove gasoline for use in his gasoline motor. Ironically, the development of Standard Oil's gasoline operation might not have taken place had it not been for John D. Rockefeller's insistence. When in 1885, sour crude was discovered in Lima, Ohio everyone except John D. believed it was worthless. He insisted on developing the field over their objections.

6 In 1899, Standard Oil of New Jersey became the central holding company for all companies in the Standard trust. In 1906, the attorney general for the state of Missouri filed suit against Standard for violating the Sherman Antitrust Act. Thus began the breaking up of Standard Oil. In 1911, the U.S. Supreme Court ordered Standard Oil of New Jersey to divest itself of holdings in 33 other companies. Standard Oil of Ohio became independent as a one-state marketer with obsolete and inadequate refining capacity. The company owned no crude, no pipelines, its assets were only $6.6 million, and its refining capacity (3,400 barrels per day) was about one third what it had been 20 years earlier.

7 Had it not been for the development of industrial and home uses for gasoline, Standard Oil of Ohio might have disappeared. But the transition from kerosene to gasoline enabled Sohio to remain a viable organization (they controlled about 85 percent of the gasoline market in Ohio).

8 As the automobile took over as the vehicle of the future, Sohio began to invest in service stations. In 1912, Sohio erected its first drive-in filling station in Columbus, Ohio. It was a simple metal shack which motorists would drive through for a fill-up. By 1914, Sohio had 12 service stations, each costing about $500. Over the next few years, Sohio would build service stations and bulk plants (distribution facilities) at a feverish pace to capitalize on the growing market for gasoline. Competition intensified as the market grew, and new western oil discovered in 1922 caused the price of gasoline to drop dramatically. Since Sohio was small relative to their competition and they were not considered by their competition to be a significant threat, excess supplies were dumped on the Ohio market. Thus in 1922, Sohio's net profit of $6.8 million was a record that would stand until 1946.

9 The depression delivered Sohio a stunning blow. From 1932 to 1934, the company showed net losses. Not until the United States entered World War II in 1941 did things improve significantly. During the war, Sohio converted its refining facilities to production of 100-octane aviation gasoline which it sold to the government.

10 The 1940s saw Sohio increasing its efforts in exploration and distribution. From 1942 to 1949, their crude oil production increased from 1,868 to 30,000 barrels per day. Distribution improved as Sohio entered joint ventures with other producers to move crude oil across land through pipelines to refining facilities.

11 In the 1950s and the 1960s, two events transformed the industry as a whole and Sohio in particular. First, the 1950s were marked by the development of the interstate highway system which opened up new opportunities for increasing retail sales to an increasingly mobile consumer. The United States had experienced the greatest depression known to it from which it took a world war to draw us out. After the war, fears and frustrations experienced by the American people for 20 years disappeared and the future looked bright.

12 At the end of the 1960s, the future looked especially bright for Sohio. In 1970, a Sohio-BP merger was approved which opened up for Sohio the largest oil reserve in the United States—Alaska's North Slope. In 1973 after considerable debate in the U.S. Congress over the environmental impact of the trans-Alaska pipeline, President Richard Nixon signed the Pipeline Authorization Act and Congress amended the National Environmental Policy Act.

13 As money flowed into the North Slope and the pipeline, Sohio lived nervously from one financing to the next. But the gamble paid off handsomely. According to *The Wall Street Journal* (January 12, 1980):

> Thanks to Alaska, Sohio has larger domestic reserves than any other American oil company. In stark contrast to its situation a decade ago, the company now produces more crude oil than it can refine. It pumps nearly 700,000 barrels a day out of Prudhoe Bay but can handle only 450,000 at its three refineries in Ohio and Pennsylvania.
>
> The concern, which didn't even qualify as a major oil company 10 years ago, ranked ninth in assets in 1978. Prudhoe Bay accounts for 80 percent of those assets, and it contributes at least 85 percent of profits. Sohio earned just $70 million in 1968; tomorrow, analysts expect it to report 1979 earnings of approximately $1.15 billion.

Industry

The history of oil and gas consumption in the United States

14 In an article prepared for the University of California at San Diego, Norman Metzger explains how the United States reached the point of almost total dependence on oil and natural gas. Metzger is senior editor in the Office of Information of the National Academy of Sciences. Excerpts from his article follow:

Both (oil and natural gas) are 20th-century fuels. Oil rose from barely measurable use around 1900 to a quarter share of total U.S. energy consumption in 1930 and almost half in 1970. Natural gas consumption quadrupled between 1930 and 1970.

Their spectacular growth has technological, political, and social roots. Repeating the 19th-century pattern for coal, we created new technologies that could take advantage of the unique properties of these fuels. The internal combustion engine is the most spectacular example.

Technological changes moved in tandem with political and social transformations that assumed energy would be available everywhere, in the form needed, and cheaply—as indeed it was.

Low-cost loans and mortgages through the G.I. Bill of Rights encouraged Americans to marry, have children, and buy their own homes, beginning the baby and suburban booms. The interstate highway program started in the 1950s, its mission to enable us to drive coast to coast without stopping for a traffic light.

These political markers were evidence of deeper social trends. Urbanization continued, the proportion of the metropolitan population doubling between 1900 and 1960. More people bought cars: By 1970, 80 percent of all families had at least one. More women went to work, with a third in the labor force in 1950 and about half by 1977.

Common to all these changes was a heightened demand for energy. In the postwar decades, the amount of energy used by each person in the United States rose steadily, indicating the increasingly higher energy content of the goods and services produced.

These exuberant needs for energy were met by oil and gas; indeed, these two fuels were vital to the growth of the American economy, where gross national product almost quintupled between 1930 and 1977. The enormous self-confidence that growth engendered, and vast discoveries in Texas, Louisiana, even Alaska, eased any anxieties about wedding ourselves almost exclusively to two finite fuels.

The internal combustion engine developed further, with horsepower a better sales lure than gas mileage; the interstate highway system was built on the premise of cheap, ubiquitous gasoline. Air traffic, prop to jet, grew spectacularly even though it is a fuel-wasting way to travel short to medium distances, compared to railroads, whose passenger role gradually eroded.

And there were all those appliances: Refrigerators replaced the ice box; washing .achines, the washboard; air conditioners, the fan. New industrial processes, such as the electric arc furnace of the steel industry, appeared. Production of plastics grew prodigiously, particularly after World War II, further raising the demand for petroleum.

And energy was cheap: Its price as a proportion of both gross national product and of personal incomes fell steadily for several decades. New oil fields were discovered; natural gas was so cheap and plentiful that its market price was set at a level to encourage its use.

But there were some ominous signs, including the very fact that the United States depended largely on two fuels. Nuclear energy was not even up to the level of hydropower—now about 4 percent—until the 1970s, and

coal's share shrank and was increasingly restricted to electrical power plants. The level of oil imports rose from about 12 percent in 1950 to half in the 1970s. And the rate of oil and gas discovery per foot drilled was falling, as easily found fields had already been tapped.

But only the politican wishing early retirement would have denied that more was better or would have pressed to conserve energy or to widen the array of fuel supplies.

Moreover, while we were raising our energy consumption, almost solely through the growth of oil and natural gas, we were foreclosing other options. For example, there was a postwar effort, through the Synthetic Fuels Act, to improve on the horrendously costly conversion processes that the Nazis had used to liquefy coal for fueling tanks and planes.

That effort withered as cheap petroleum became more widely available, as natural gas found national markets, and as the petroleum industry continued its opposition to government support of alternative energy sources. The result was to impoverish coal research, and to limit coal's role as an alternative to increasing imports of ever more costly oil.

And there was a seemingly unlimited supply of oil to import. In the 1950s, new geophysical techniques led to the discovery of large oil deposits in Kuwait, Abu Dhabi, the United Arab Emirates, Saudi Arabia, and Iran. Production costs from these new wells were only 5 to 40 cents per barrel compared to $2 to $6 in the United States. American oil companies pressed for an oil import program, which by "protecting" the nation from cheaper foreign oil, accelerated the depletion of domestic supplies.

The environmental movement, which began in the 1960s, gained strength as the true price of energy became more apparent—air polluted by fossil-fueled power plants and automobiles; water heated as it coursed through nuclear power plants before spilling into rivers and lakes; oil slicks on Santa Barbara Bay and the English Channel.

The attack was well justified, but the immediate response led to other problems. For example, believing that sulfur dioxide from smoke stacks caused air pollution, the government restricted the burning of high-sulfur coals. But the effects of suddenly depriving utilities of high-sulfur coals—for which they had built plants, structured their rates, arranged transportation, intensively sought customers—were not thought out. Many utilities switched to low-sulfur oil rather than compete in a seller's market for low-sulfur coal, raising the demand for petroleum and refinery capacity beyond anything anticipated by the petroleum industry.

Also, the problems of coal raised the already high and, in retrospect, deceptive, attractions of nuclear fission for producing electricity.

The fortunes of oil and gas were thus deeply woven into transformations that occurred in American society beginning in the 1930s. These energy choices reflected what American society valued. It wanted oil and gas partly because of their convenience compared to coal. In turn, the changes that oil and gas made possible—from the automobile age to "clean heat"—entered our definition of a reasonable standard of life. And in time, the environmental movement signaled that clean rivers and air were sometimes of more value than an economy premised on ever more goods.

When the price of OPEC oil quintupled in the 1970s, the situation was ripe for an energy crisis.

The worldwide oil and gas situation

15 The United States is not alone in its reliance on oil and natural gas as its primary energy source. With industrialization taking place throughout the world and with increased standards of living resulting from industrialization (and thus increased energy demand), the pressure on oil and gas producers and refiners is intensifying. Exhibits 1 through 5 present data pertaining to world oil reserves, world refining capacities, world oil production, and world

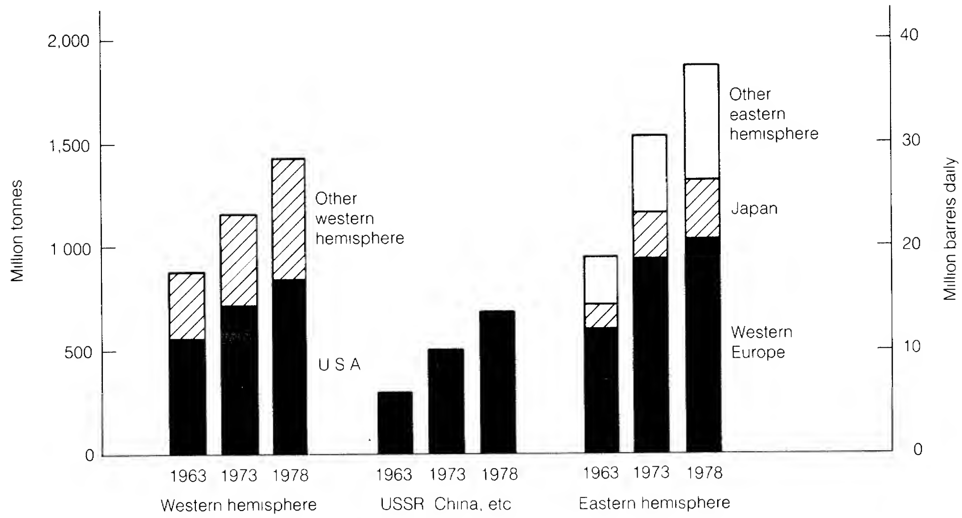
exhibit 1
World "published proved" reserves at end 1978

	Oil			*Natural Gas*		
Country/area	*Thousand million tonnes*	*Share of total*	*Thousand million barrels*	*Trillion* cbic feet*	*Share of total*	*Trillion* cubic metres*
U.S.A.	4.4	5.2%	33.7	200.3	7.9%	5.7
Canada	1.1	1.3	8.3	82.0	3.2	2.3
Total North America	5.5	6.5	42.0	282.3	11.1	8.0
Latin America	5.8	6.4	41.2	113.0	4.5	3.2
Total western hemisphere	11.3	12.9	83.2	395.3	15.6	11.2
Western Europe	3.3	3.7	24.3	143.8	5.7	4.1
Middle East	50.3	56.9	369.6	730.2	29.0	20.7
Africa	7.7	8.9	57.9	186.3	7.4	5.3
USSR	9.7	10.9	71.0	910.0	36.1	25.8
Eastern Europe	0.8	0.5	3.0	10.0	0.4	0.3
China	2.7	3.1	20.0	25.0	1.0	0.7
Other eastern hemisphere	2.7	3.1	20.0	119.9	4.8	3.4
Total eastern hemisphere	76.8	87.1	565.8	2 125.2	84.4	60.3
World (excluding USSR, Eastern Europe, and China)	75.3	85.5	555.0	1 575.5	62.5	44.7
World	88.1	100.0	649.0	2 520.5	100.0	71.5

* Trillion: 10^{12}; 1 million million.
Source of data:
United States: American Petroleum Institute and American Gas Association.
Canada: Canadian Petroleum Association.
All other areas: Estimates published by the *Oil and Gas Journal* (Worldwide Oil issue—December 25, 1978).
Notes:
1. Proved crude oil reserves are generally taken to be the volume of oil remaining in the ground which geological and engineering information indicates with reasonable certainty to be recoverable in the future from known reservoirs under existing economic and operating conditions.
2. The recovery factor, i.e., the relationship between proved reserves and total oil in place varies according to local conditions and can vary in time with economic and technological changes.
3. For the U.S.A. and Canada the oil data include natural gas liquids which it is estimated can be recovered from proved natural gas reserves.
4. The data exclude shale oil and tar stands.
5. Percentages are based on volume.

Source: *BP Statistical Review of the Oil Industry*, 1978.

exhibit 2
World oil refining capacities 1968, 1973, and 1978



Source: *BP Statistical Review of the Oil Industry*, 1978.

oil consumption. Exhibit 6 presents data pertaining to natural gas consumption.

Financial position of 27 major firms in the petroleum industry

16 In 1977, the Chase Manhattan Bank conducted a study into the financial position of 27 major petroleum producers. Some of their findings are presented in Exhibits 7 through 10. Exhibit 7 lists the 27 firms in the study, and Exhibits 8 through 10 present relevant aggregate financial data.

U.S. energy policy seems imminent

17 Since he took office in 1977, President Carter urged the adoption of a national energy policy. His plan, presented in the spring of 1977, focused on voluntary conservation, conversion to coal, and development of alternatives to meet our long-run energy needs. Passage of energy legislation has been slow at best. President Carter bemoans the reluctance of Congress to face the energy problem, but it appears Congress is ready to move. These excerpts from *The Wall Street Journal* (February 27, 1980) discuss the characteristics of upcoming energy legislation.

exhibit 3

World oil production (000 barrels daily)

Country/area	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	Yearly change: 1978 over 1968	Yearly change: 1978 over 1973
United States:													
Crude oil	9 095	9 240	9 635	9 465	9 440	9 210	8 795	8 375	8 130	8 245	8 700	0.5%	1.1%
Natural gas liquids	1 505	1 590	1 660	1 695	1 745	1 740	1 685	1 635	1 605	1 620	1 565	+ 0.3	2.0
Total	10 600	10 830	11 295	11 160	11 185	10 950	10 480	10 010	9 735	9 865	10 265	− 0.4	1.2
Canada	1 195	1 310	1 475	1 585	1 830	2 115	2 000	1 735	1 605	1 610	1 575	+ 2.5	− 6.2
Total North America	11 795	12 140	12 770	12 745	13 015	13 065	12 480	11 745	11 340	11 475	11 840	—	− 2.0
Latin America:													
Argentina	345	355	390	425	435	420	415	390	390	430	455	+ 2.8	+ 1.5
Brazil	165	175	165	170	165	165	175	170	170	165	165	—	− 0.3
Colombia	175	210	220	215	195	185	170	160	145	140	130	− 2.8	− 6.7
Ecuador	5	5	5	5	80	210	175	160	185	190	205	+44.9	− 0.4
Mexico	440	460	485	485	505	550	640	790	875	1 085	1 330	+11.8	+ 19.7
Trinidad	185	155	140	130	140	165	180	215	215	230	230	+ 2.0	+ 6.1
Venezuela	3 645	3 630	3 760	3 620	3 305	3 460	3 065	2 425	2 375	2 315	2 235	− 4.9	− 8.4
Other Latin America	165	150	135	135	160	170	165	150	155	160	215	+ 2.9	+ 5.5
Total Latin America	5 125	5 140	5 300	5 185	4 985	5 325	4 985	4 460	4 510	4 715	4 965	− 0.5	− 1.5
Total western hemisphere	16 920	17 280	18 070	17 930	18 000	18 390	17 465	16 205	15 850	16 190	16 805	− 0.2	− 1.8
Western Europe:													
Austria	55	55	55	50	50	50	45	40	40	35	35	− 4.1	− 7.0
France	55	50	45	35	30	25	20	20	20	20	20	− 8.4	− 2.3
Italy	30	35	30	25	20	20	20	20	20	20	25	− 1.1	+ 6.7
Norway	—	—	—	5	30	35	35	190	280	275	350	—*	+ 57.1
Turkey	60	70	70	70	65	70	65	60	50	55	55	− 1.4	− 5.1
United Kingdom	—†	—†	—†	—†	—†	—†	—†	25	235	780	1 095	+91.4	+251.1
West Germany	155	155	150	145	140	130	120	115	110	105	100	− 4.5	− 5.3
Yugoslavia	50	55	60	60	65	65	70	80	80	80	85	+ 5.1	+ 4.5
Other Western Europe	45	40	40	35	30	45	70	70	70	55	55	+ 2.3	+ 3.7
Total Western Europe	450	460	450	425	430	440	445	620	905	1 425	1 820	+14.6	+ 31.7

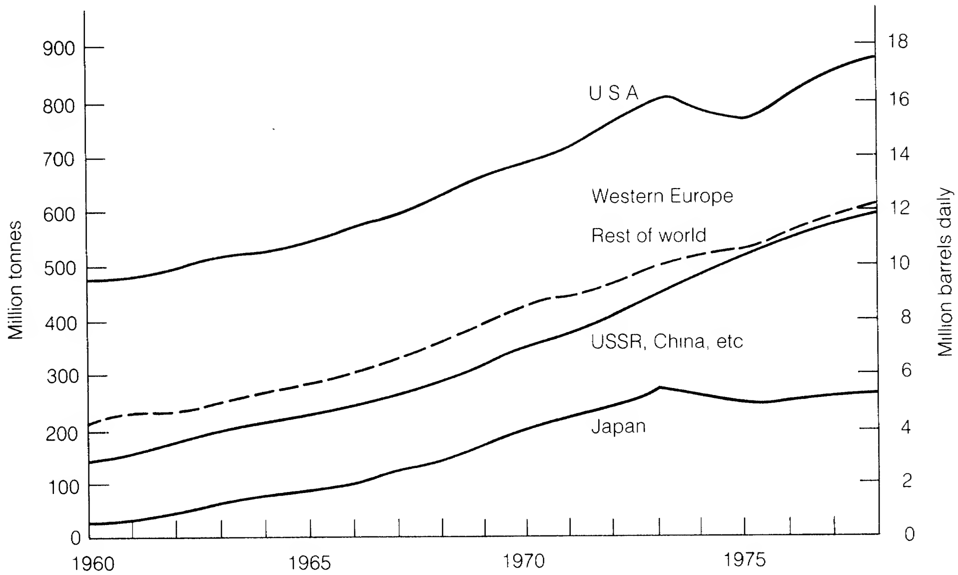
exhibit 3
World oil production (000 barrels daily) *(concluded)*

Country/area	*1968*	*1969*	*1970*	*1971*	*1972*	*1973*	*1974*	*1975*	*1976*	*1977*	*1978*	*Yearly change* 1978 over 1968	*Yearly change* 1978 over 1973
Middle East:													
Abu Dhabi	495	600	695	935	1 050	1 305	1 410	1 400	1 595	1 665	1 450	+11.3	+ 2.2
Dubai	—	10	85	125	155	220	240	255	315	320	360	—*	+ 10.7
Iran	2 840	3 375	3 845	4 565	5 050	5 895	6 060	5 385	5 920	5 705	5 235	+ 6.3	− 2.3
Iraq	1 505	1 525	1 565	1 700	1 465	2 020	1 970	2 260	2 415	2 495	2 600	+ 5.6	+ 5.2
Kuwait	2 420	2 575	2 735	2 925	3 000	2 755	2 275	1 840	1 950	1 785	1 865	− 2.6	− 7.5
Neutral zone	405	420	505	545	565	535	540	500	465	355	460	+ 1.3	− 2.8
Oman	240	330	330	285	280	295	290	340	365	340	315	+ 2.7	+ 1.4
Qatar	340	355	370	430	485	570	520	435	485	435	480	+ 3.7	− 3.1
Saudi Arabia	2 830	2 995	3 550	4 500	5 730	7 345	8 350	6 970	8 525	9 235	8 270	+11.2	− 2.3
Sharjah	—	—	—	—	—	—	30	40	35	30	20	—*	—*
Other Middle East	95	130	165	175	185	175	190	245	250	235	235	+ 9.5	+ 6.2
Total Middle East	11 170	12 315	13 845	16 185	17 965	21 115	21 875	19 670	22 320	22 600	21 290	+ 6.6	+ 0.1
Africa:													
Algeria	915	955	1 040	780	1 060	1 095	1 010	1 020	1 075	1 150	1 230	+ 2.9	+ 2.2
Egypt	220	340	465	415	350	255	230	295	325	415	480	+ 8.0	+ 13.3
Gabon	95	100	110	115	125	150	200	225	225	220	215	+ 8.8	+ 7.5
Libya	2 605	3 110	3 320	2 765	2 240	2 180	1 520	1 480	1 930	2 065	1 975	− 2.7	− 1.9
Nigeria	145	540	1 085	1 530	1 815	2 055	2 260	1 785	2 065	2 095	1 920	+29.4	− 1.0
Other North Africa	70	80	90	90	85	80	85	95	75	100	100	+ 3.7	+ 4.6
Other West Africa	25	55	110	115	140	190	225	205	165	230	195	+23.7	+ 0.7
Total Africa	4 075	5 180	6 220	5 810	5 815	6 005	5 530	5 105	5 860	6 275	6 115	+ 4.2	+ 0.5
South Asia	140	150	165	175	185	180	180	195	200	305	320	+ 8.1	+ 11.0

Southeast Asia:													
Brunei	120	130	140	150	175	235	200	190	205	220	205	+ 5.3	− 2.7
Indonesia	600	750	855	890	1 080	1 335	1 375	1 305	1 505	1 690	1 635	+10.6	+ 4.2
Other Southeast Asia	5	10	20	70	75	90	80	90	155	190	250	+51.1	+ 23.1
Total Southeast Asia	725	890	1 015	1 110	1 330	1 660	1 655	1 585	1 865	2 100	2 090	+11.2	+ 4.8
Japan	15	15	15	15	15	15	15	10	10	10	10	− 3.0	− 4.8
Australasia	40	40	180	310	355	385	385	415	430	450	450	+27.8	+ 2.9
USSR	6 190	6 595	7 090	7 470	7 890	8 455	9 075	9 740	10 315	11 045	11 705	+ 6.3	+ 6.3
Eastern Europe	350	345	355	365	385	385	395	400	400	410	430	+ 1.9	+ 1.8
China	305	410	565	735	845	1 100	1 320	1 490	1 675	1 810	1 930	+20.2	+ 11.9
Total eastern hemisphere	23 460	26 400	29 900	32 600	35 215	39 740	40 875	39 230	43 980	46 430	46 160	− 6.9	+ 2.9
World (excluding USSR, Eastern Europe and China)	33 535	36 330	39 960	41 960	44 095	48 190	47 550	43 805	47 440	49 355	48 900	+ 3.8	+ 0.8
World	40 380	43 680	47 970	50 530	53 215	58 130	58 340	55 435	59 830	62 620	62 965	+ 4.5	+ 1.5

˜ Greater than 300 percent.
† Data not available.
Source: *BP Statistical Review of the Oil Industry*, 1978.

exhibit 4
World oil consumption 1960–1978



Source: *BP Statistical Review of the Oil Industry, 1978.*

"I'd say I think we will have something that we can call a national energy policy fairly soon," says Edward Mitchell, a University of Michigan professor and the director of energy studies for the conservative American Enterprise Institute. While he has strong reservations about the program, Mitchell says, "There is a sort of point of view, a philosophy underlying the various elements." That philosophy: "Reduce demand and divorce ourselves from the oil cartel."

The energy program as originally proposed by the president aimed to halve U.S. oil imports by 1990 from the 8.5 million to 9.5 million barrels a day that it's estimated will be coming into the country by that date. While Congress has softened some of Carter's targets a bit, the plan still represents a sharp move away from foreign oil, which is currently being imported at a rate of about 8.4 million barrels a day.

To meet the targets, the strategy will emphasize conserving energy, mostly through higher prices but also through fuel-efficiency standards in autos, buildings, equipment, and the like, and through economic incentives such as tax credits. Other details:

Holding domestic crude-oil production steady or slowing its rate of decline that is expected as the United States runs out of easily exploited reserves.

Increasing the use of other energy sources, including coal and, despite its many problems, nuclear power.

Establishing important new energy sources, including synthetic fuels and, later, solar power and nuclear fusion.

Officials say there already is evidence that their strategy will hold down demand. They point to 1979 when world oil prices doubled, and they say it isn't a coincidence that U.S. oil consumption declined for the first time in four years. The only way to wean the country from its foreign-oil dependence, Duncan says, is to price energy at its "true cost"—the cost of developing new energy to replace the energy being consumed.

Decontrol, especially of oil, "was a courageous step" by President Carter, says Charles DiBona, president of the American Petroleum Institute, the group whose members stand to profit from the move. "No politican likes the consequences of the actions that have to be taken for a rational energy policy," he says.

The windfall profits tax

18 According to *The Wall Street Journal* (February 22, 1980), the "windfall profits tax approved by House and Senate conferees will draw into the federal coffer about 70 percent of the additional money that would have gone to oil producers because of price decontrol. Government economists estimate decontrol will add an additional $1 trillion to the revenues of the oil producers between 1979 and 1990. After paying production costs, existing taxes and royalties (local, state, and federal), and the windfall tax, oil producers will receive about $221 billion of the $1 trillion dollars raised. The windfall tax alone will cost oil companies $227.3 billion. Sixty percent of the windfall tax will be used to cut taxes for individuals and corporations; 25 percent will go to aid the poor; and 15 percent will be used for government grants for loans to help save or produce energy.

19 In a letter to the author of this case dated February 15, 1980, R. B. Nash, manager of investor relations for Sohio, described the windfall profits tax as "an excise tax on production." According to Nash, "the passage of legislation authorizing such a tax sets a dangerous precedent not only for the oil industry but for all American industries." In *Shareholder News* (September 30, 1979), a Sohio publication, Richard M. Donaldson (vice president of government and foreign affairs) said the windfall tax would cost Sohio "several billion dollars—funds that otherwise would be available for domestic energy development . . . decisions like that (the windfall tax) can only add to the discouragement that industry is facing in seeking new sources of energy in frontier areas."

An expert's view of the oil industry

20 The author interviewd Dr. Fred Singer of the University of Virginia to solicit his views on the energy situation. Dr. Singer served as deputy assistant

exhibit 5
World oil consumption (thousand barrels daily)

Country/area	1968	1969	1970	1971	1972	1973	1974	1975	1'76	1977	1978	Yearly change 1978 over 1968	Yearly change 1978 over 1973
U.S.A.*	13 085	13 815	14 350	14 845	15 990	16 870	16 150	15 875	16 980	17 925	18 345	+ 3.4%	+1.7%
Canada	1 375	1 440	1 525	1 585	1 655	1 755	1 785	1 735	1 790	1 810	1 835	+ 2.8	+0.8
Total North America	14 460	15 255	15 875	16 430	17 645	18 625	17 935	17 610	18 770	19 735	20 180	+ 3.3	−1.6
Latin America	2 440	2 610	2 820	3 035	3 180	3 435	3 595	3 655	3 850	3 990	4 190	+ 5.4	+4.3
Total western hemisphere	16 900	17 865	18 695	19 465	20 825	22 060	21 530	21 265	22 620	23 725	24 370	+ 3.7	+2.0
Western Europe													
Austria	150	160	185	205	215	235	210	215	230	225	240	+ 4.8	+0.3
Belgium and Luxembourg	440	500	560	570	620	635	560	535	560	565	575	+ 2.6	−2.1
Denmark	275	330	365	365	385	360	320	315	335	330	325	+ 1.6	−2.2
Finland	165	190	210	220	235	260	230	235	255	250	250	+ 4.3	−1.1
France	1 470	1 705	1 920	2 090	2 315	2 585	2 460	2 255	2 430	2 350	2 445	+ 5.2	−1.3
Greece	115	125	135	150	170	200	185	195	210	215	240	+ 7.6	+3.8
Iceland	10	10	10	10	10	15	15	10	10	10	10	+ 1.3	−1.7
Republic of Ireland	70	75	80	90	100	110	110	105	105	115	120	+ 5.9	+2.0
Italy	1 385	1 530	1 740	1 875	1 965	2 070	2 015	1 895	2 065	1 920	1 995	+ 3.5	−0.8
Netherlands	590	650	725	720	805	835	725	710	795	770	775	+ 2.1	−2.1
Norway	135	150	165	165	170	175	160	165	180	180	175	+ 2.7	+0.3
Portugal	70	80	95	115	120	130	135	140	145	150	150	+ 7.8	+3.2
Spain	435	495	565	635	655	790	820	865	970	930	965	+ 8.1	+3.7
Sweden	470	530	590	560	565	585	540	535	590	560	535	+ 1.1	−2.0
Switzerland	210	230	260	275	280	300	270	260	270	270	280	+ 2.7	−1.7
Turkey	130	140	155	180	200	250	255	275	310	340	310	+ 9.1	+4.1
United Kingdom	1 840	1 980	2 095	2 105	2 230	2 300	2 135	1 875	1 860	1 885	1 930	+ 0.4	−3.6
West Germany	2 135	2 240	2 655	2 745	2 885	3 070	2 760	2 655	2 855	2 855	2 955	+ 3.2	−1.0
Yugoslavia	95	120	140	180	205	225	235	245	265	280	300	+11.9	+5.8
Cyprus/Gibraltar/Malta	20	20	20	25	25	25	25	20	25	25	25	+ 4.8	+1.1
Total Western Europe	10 210	11 440	12 670	13 280	14 155	15 155	14 165	13 505	14 465	14 225	14 600	+ 3.5	−0.9

Middle East	795	920	966	1 055	1 115	1 210	1 320	1 320	1 475	1 565	1 655	+ 7.3	+6.0
Africa	735	795	855	900	920	1 000	1 035	1 050	1 135	1 175	1 240	+ 5.3	+4.2
South Asia	455	535	540	565	585	635	600	610	665	705	760	+ 5.1	+3.4
Southeast Asia	975	1 075	1 180	1 265	1 415	1 540	1 585	1 630	1 770	1 915	2 115	+ 8.1	+6.4
Japan	2 850	3 390	4 000	4 435	4 735	5 460	5 270	5 020	5 190	5 350	5 420	+ 6.3	−0.5
Australasia	540	575	620	650	660	725	750	735	770	800	800	+ 3.8	+1.6
USSR	4 545	4 875	5 290	5 540	5 970	6 425	6 905	7 255	7 670	8 025	8 385	+ 6.2	+5.4
Eastern Europe	885	1 015	1 115	1 225	1 355	1 550	1 660	1 730	1 845	1 955	2 070	+ 8.6	+5.5
China	300	400	560	725	855	1 065	1 225	1 350	1 530	1 630	1 705	+18.7	+9.5
Total Eastern Hemisphere	22 290	25 020	27 795	29 640	31 765	34 765	34 515	34 205	36 515	37 345	38 750	+ 5.5	+2.0
World (excluding USSR Eastern Europe and China)	33 460	36 595	39 525	41 615	44 410	47 785	46 255	45 135	48 090	49 460	59 960	+ 4.2	+1.2
World	39 190	42 885	46 490	49 105	52 590	56 825	56 045	55 470	59 135	61 070	63 120	+ 4.8	+2.0

` U.S. processing gain has been deducted from local domestic product demand.
Source: *BP Statistical Review of the Oil Industry*, 1978.

exhibit 6

World natural gas consumption (million tonnes oil equivalent)

Country/area	*1968*	*1969*	*1970*	*1971*	*1972*	*1973*	*1974*	*1975*	*1976*	*1977*	*1978*	*Yearly change* 1978 over 1968	*Yearly change* 1978 over 1973
U.S.A.*	522.2	561.2	564.1	584.2	587.4	572.3	555.1	508.7	516.4	502.3	504.2	− 0.4%	− 2.5%
Canada	26.5	29.6	32.7	34.9	39.3	41.8	42.2	43.1	46.1	45.9	47.3	+ 6.0	+ 2.5
Total North America	548.7	590.8	596.8	619.1	626.7	614.1	597.3	551.8	562.5	548.2	551.5	+ 0.1	− 2.1
Latin America	32.3	34.1	30.4	32.6	36.4	36.5	37.8	39.2	40.5	39.6	42.3	+ 2.7	+ 3.0
Total western hemisphere	518.0	624.9	627.2	651.7	663.1	650.6	635.1	591.0	603.0	587.8	593.8	+ 0.2	− 1.8
Western Europe													
Austria	1.8	2.2	2.5	2.9	3.1	3.4	3.7	3.6	4.1	4.2	4.5	+ 9.8	+ 5.6
Belgium and Luxembourg	1.3	2.6	4.2	5.8	6.7	8.2	9.8	9.6	10.3	10.1	10.5	+ 23.5	− 5.1
Denmark	—	—	—	—	—	—	—	—	—	—	—	—	—
Finland	—	—	—	—	—	—	—	—	—	—	—	—*	—*
France	7.1	8.5	9.3	11.1	13.2	15.7	17.2	17.0	19.0	20.4	20.9	+ 11.4	− 5.9
Greece	—	—	—	—	—	—	—	—	—	—	—	—	—
Iceland	—	—	—	—	—	—	—	—	—	—	—	—	—
Republic of Ireland	—	—	—	—	—	—	—	—	—	—	—	—	—
Italy	9.7	11.2	12.3	12.5	12.3	14.4	15.8	18.0	22.0	21.6	24.4	+ 9.7	+11.1
Netherlands	9.1	13.4	19.1	24.6	29.0	32.2	32.1	33.2	33.0	33.4	34.0	+ 14.0	+ 1.1
Norway	—	—	—	—	—	—	—	—	—	—	—	—	—
Portugal	—	—	—	—	—	—	—	—	—	—	—	—	—
Spain	—	0.1	0.1	0.4	1.0	1.0	1.3	1.3	1.5	1.4	1.5	—*	+ 7.8
Sweden	—	—	—	—	—	—	—	—	—	—	—	—	—
Switzerland	—	—	—†	—†	0.1	0.2	0.4	0.6	0.5	0.6	0.7	—*	+32.0
Turkey	—	—	—	—	—	—	—	—	—	—	—	—	—
United Kingdom	3.0	5.9	11.2	18.1	25.2	26.1	31.8	32.9	34.6	36.9	37.9	+ 29.0	+ 7.7
West Germany	6.6	9.2	13.0	16.9	21.5	27.0	32.5	34.4	36.3	38.9	42.1	+ 20.4	+ 9.4
Yugoslavia	0.5	0.7	0.9	1.1	1.4	1.7	2.3	2.2	1.5	1.7	1.6	+ 11.3	− 0.7
Cyprus/Gibraltar/Malta	—	—	—	—	—	—	—	—	—	—	—	—	—
Total Western Europe	39.1	53.8	72.6	93.4	113.5	129.9	147.3	153.5	163.6	169.9	178.9	+ 16.4	+ 6.6

Middle East	7.6	11.3	19.0	19.0	21.0	24.1	27.6	26.2	26.9	28.8	30.1	+ 14.7	+ 4.5
Africa	1.2	1.4	1.5	1.7	2.4	3.2	3.6	4.3	5.1	6.9	8.3	+ 21.4	+21.1
South Asia	4.0	4.8	5.4	6.0	6.8	8.0	7.9	8.1	8.8	9.4	9.7	+ 9.3	+ 3.9
Southeast Asia	2.0	2.0	2.3	2.3	2.4	3.6	4.3	4.1	4.2	4.6	7.9	+ 15.0	+17.3
Japan	2.2	2.4	3.6	3.8	3.7	5.3	7.0	8.5	10.4	13.0	17.0	+ 23.0	+26.2
Australasia	—†	0.2	1.5	2.2	3.2	3.9	4.6	4.9	6.1	7.4	7.8	+104.9	+15.0
USSR	157.5	168.3	184.8	201.4	188.5	200.4	215.7	235.0	250.0	284.0	289.0	+ 6.3	+ 7.6
Eastern Europe	26.3	31.4	34.5	37.5	35.3	39.4	43.7	50.0	55.0	60.0	65.0	+ 9.5	+10.5
China	1.1	1.9	3.3	5.2	8.3	12.5	17.5	22.7	27.3	30.0	33.0	+ 40.5	+21.4
Total Eastern Hemisphere	241.0	277.5	328.5	372.5	385.1	430.3	479.2	517.3	557.4	614.0	646.7	+ 10.4	+ 8.5
World (excluding USSR Eastern Europe and China)	637.1	700.8	733.1	780.1	816.1	828.6	837.4	800.6	828.1	827.8	853.5	+ 3.0	+ 0.6
World	822.0	902.4	955.7	1 024.2	1 048.2	1 080.9	1 114.3	1 108.3	1 160.4	1 201.8	1 240.5	+ 4.2	+ 2.8

† = Less than 0.05 million tonnes oil equivalent.
* Greater than 300 percent.
Source: *BP Statistical Review of the Oil Industry*, 1978.

exhibit 7
Companies included in study

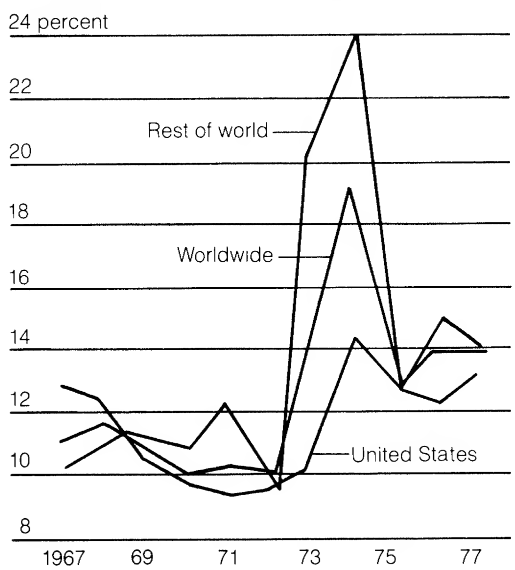
Amerada Hess Corporation	Marathon Oil Company
Ashland Oil, Inc.	Mobil Oil Corporation
Atlantic Richfield Company	Murphy Oil Corporation
The British Petroleum Company Limited	Petrofina Societe Anonyme
Champlin Petroleum Company	Phillips Petroleum Company
Cities Service Company	Royal Dutch/Shell Group of Companies
Clark Oil & Refining Corporation	Standard Oil Company of California
Compagnie Francaise des Petroles	Standard Oil Company (Indiana)
Continental Oil Company	The Standard Oil Company (Ohio)
Exxon Corporation	Sun Company, Inc.
Getty Oil Company	The Superior Oil Company
Gulf Oil Corporation	Texaco Inc.
The Louisiana Land and Exploration Company	Tosco Corporation
	Union Oil Company of California

Source: *Financial Analysis of a Group of Petroleum Companies,* 1977.

secretary of interior under President Nixon, and he has studied oil security problems as a consultant to the Treasury Department. Excerpts from that interview follow.

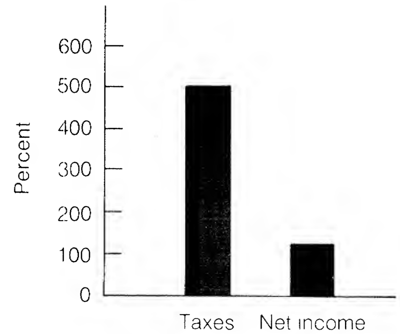
Q: What is your view of the political situation the oil industry faces today:

exhibit 8
Return on average invested capital



Source: *Financial Analysis of a Group of Petroleum Companies,* 1977.

exhibit 9
Change over past 10 years

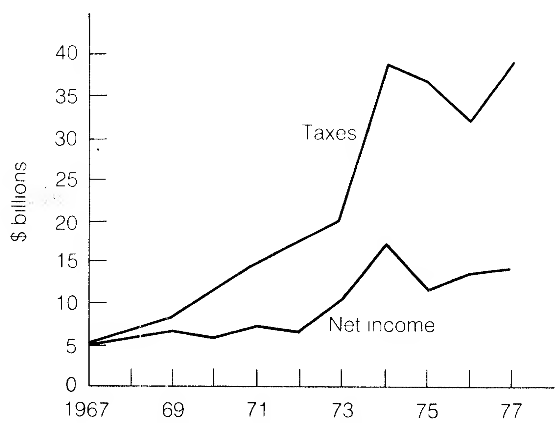


Source: *Financial Analysis of a Group of Petroleum Companies*, 1977.

A: From the point of the oil industry, not very good. The public, by and large, views the oil industry in an unfavorable light. It is hard for me to tell whether this is a consequence of the statement of the President [Carter] or whether the president is simply following what he regards as public opinion. There is no doubt that they reinforce each other. Congress, by and large, has about the same view although it is divided. Some members of Congress obviously feel, or at least they state, that the oil industry is making obscene profits and taking advantage of the public and other members of the Congress feel differently.

Q. What is your view of the response of firms representing the oil industry to the energy problem since it has been widely known the problem exists for more than a decade?

exhibit 10
Net income in relation to taxes



Source: *Financial Analysis of a Group of Petroleum Companies*, 1977.

A. The energy problem, as I see it, is largely one of living within very difficult regulatory requirements, on the one hand, and a distorted price picture on the other hand caused mainly by the OPEC monopoly. Within those two very difficult constraints, I think the oil industry has been doing reasonably well in attempting to do what they should do—which is to produce, refine, and sell oil.

The planning, of course, has been very much upset by many unanticipated happenings, such as assembly delay on the Alaskan pipeline which caused a real drop in U.S. oil production. That was unexpected or unanticipated by the oil companies. Delays in construction of coal mines and especially nuclear power plants increased oil consumption unexpectedly. The most important, the sudden appearance of air pollution legislation (I stress the suddenness here), which caused utilities to demand and consume increased amounts of diesel fuel or number two oil starting around 1971, which put a real crimp in the oil supply situation in the United States.

Q: Do you think oil companies were doing a good job of forecasting these kinds of developments prior to 1971?

A: No, they did not do well in forecasting them, nor do I think anyone else did. Certainly the government did not do well in forecasting them. Otherwise, they would be able to forecast all these things. They might not have done things so suddenly or precipitantly, and maybe the OPEC position would not have arisen. The strong position of OPEC in 1973 was largely due to the fact that U.S. production declined and we suddenly became very dependent on oil imports, and so was the rest of the world.

Q: What was the effect of the 1971 price controls on the ability of oil producers to pursue new oil exploration?

A: Well, it put a real crimp into their cash flow and the only ones who were exempted were producers of stripper wells, but they never accounted for very much of U.S. oil production. I think a total of 11 percent of production came from stripper wells who were exempted from price controls. The others, of course, found it unprofitable to go after new oil in view of the fact they could not get higher prices. After the 1973 price rise, there occurred a serious distortion because of the price controls on domestic oil. Higher prices from abroad caused the entitlements program to appear, and that is a subject all by itself.

Q: How do you view the future of the domestic oil industry, especially insofar as the windfall profits tax is going to affect their future?

A: We really can't talk about the domestic oil industry in one word. We must distinguish between the small independents, large independents, and integrated companies. I think the small independents are going to do well, some of the large independents will do pretty well, and I think the integrated companies are going to do rather poorly because there will probably be a squeeze in the refinery margin and the marketing margin.

Q: In your article published in *The Wall Street Journal,* January 11, 1980, you were talking about the probability of a price drop in the next few weeks, months, years, whatever, as there continues to be a glut. How would you assess the immediate future?

A: Well, in 1979, you saw a situation where price was no longer controlled by strict economics, but by speculation. The same way gold prices are controlled by speculation. This is unusual. It has not happened for oil, at least not for an

extended period. That means the price can drop just as suddenly as it rises. The price of gold dropped yesterday.

Q: I continue to hear there is nothing the United States can do about this oil monopoly, the OPEC nations. Do you agree with that?

A: I think it is immaterial. The only question is price. OPEC, as such, is not important. That is to say, people outside OPEC will charge as much as people inside OPEC. OPEC itself has no real power. The price will be largely controlled by Saudia Arabia, and the question is whether they will expand their production or not. I am reasonably convinced that they will expand their production slowly just to keep the price of oil near what they consider to be the best price from their point of view.

Q: Are the Saudia Arabian's strongly pro-American or are they in effect taking advantage of a bad situation?

A: Both, I think they are pro-American and they are taking advantage of the situation. I don't think they let their feelings about the United States get in their way of making profits. They know we will come to their aid, so they don't have to be particularly friendly to us.

Q: What is the wisdom in the government's leasing lands to oil companies for exploration? Wouldn't it be more advantageous for the government to encourage exploration by, in effect, subsidizing the companies by allowing them to drill on public lands at no cost?

A: How would you allocate it, except by auctioning it off? No, I see nothing wrong with it. It is a way of siphoning off profits, and it is an automatic way, much preferred to the windfall profits tax.

Q: So you are not in favor of the windfall profits tax?

A: No, not the way it is currently set up. I prefer a severance tax which diminishes as the wells get older. None of these exemptions for small producers that only produce 1,000 barrels a day. That amounts to $30,000 a day which is $10 million a year.

Q: In your position in the department of the Interior, I thought, I just assumed, that the people with the Environmental Protection Agency, the Department of the Interior, and HEW were all liberally minded. You seem to have a relatively conservative view of government and business and the relationship between the two.

A: That is why. Because I have been in it, and I seek how it works. I think the energy industry would benefit from benign neglect by government. There are all sorts of ways of collecting taxes that would not distort things unduly. And, also, I think there are ways of cutting some subsidies which now exist for some parts of the energy industry. The energy industry is very complicated. At the same time the government penalizes some parts of the industry, it takes other parts of the industry and subsidizes them. This is very little known. Small refiners, for example, have been subsidized to the hilt, for no good reason.

Q: Are our energy resources very limited?

A: No, we will never run out of energy resources as such. We never will even run out of oil—in the sense that there will always be oil in the ground. I have calculated that by the year 2050, oil will be mostly phased out. The world will have used 2 trillion barrels of oil by that year. Those are not very precise

estimates of course, but what is interesting is that at the time the amount of unrecovered oil in the ground will be 6 or 7 trillion barrels. It will be just too expensive to get at, even at prices in that year.

Energy alternatives

21 According to energy experts, the United States faces serious oil shortages in the near future. Our domestic oil reserves are sufficient to meet our needs for about four years if we import no foreign crude, and the reliability of our foreign suppliers is uncertain.

22 While consumption of oil in this country has soared to about 6.5 billion barrels per year, our ability to find and develop new oil reserves has not kept pace. Experts believe domestic oil remains which can be found, but the cost of finding and developing it is high. For example, shale oil has been discussed as a possible domestic alternative, but until recently the production of shale oil could not be justified economically. Additionally, there are significant political problems associated with developing shale oil. Alaska and the offshore terrain around the continental shelf are believed to be the most promising areas for new domestic oil and gas discoveries.

23 Political upheaval in the Middle East and the possible disruption of oil supplies flowing into the United States can have a devastating effect on our economy. The results of the Arab oil embargo of 1973–1974 and the Iranian crisis of 1978–1980 are excellent examples of this phenomenon.

24 The transition to domestic energy sources capable of meeting the needs of the United States is still far away. Much research remains to be done before efficient technologies can be developed which will provide a sufficient supply of energy at a reasonable price. In the interim, alternate sources of energy which will meet our needs during the transition period must be found.

25 **Coal.** The use of coal as a substitute for oil is an alternative which offers a partial, short-term solution to the energy problem, but the transition to coal is not without difficulties. Don E. Kash, a professor at the University of Oklahoma, stressed the limitations of coal in an article he wrote for the University of California at San Diego. According to Professor Kash,

> Coal offers the nation its clearest opportunity for an assured energy source through the transition. Domestic coal resources are huge, easily sufficient to carry us to our solar and/or nuclear future.
>
> But coal poses a seemingly endless number of problems and challenges. We are still developing techniques and standards for mining coal in ways that minimize the damage to the nation's land and water—and to the miners' health.
>
> Direct burning of coal raises serious pollution problems. Because of the impacts of air pollution on the environment and human health, the government requires the use of clean-up technologies by electric utilities and large-scale users before much of the nation's coal can be burned. Major differences exist over the adequacy and need for such clean-up technologies

as the stack gas scrubbers, which take sulfur dioxide out of power plant smoke. No one, however, disagrees that scrubbers increase the cost of energy.

Management of pollution is only one of the barriers to substituting coal for oil and gas. Better than half the homes in America have gas furnaces. With minuscule exceptions, our whole transportation system requires gasoline or fuel oil. Coal can help to meet these needs only if it is converted to gaseous or liquid energy forms. Although they exist in other countries, not a single commercial coal conversion facility is operating in the United States.

In his TV address to the nation following the Camp David policy review in July 1979, President Carter proposed a major coal synthetics program. Even if it were to lead to the proposed production of 2.5 million barrels of synthetic oil by 1990—at a capital cost of more than $100 billion—this massive effort would meet less than 15 percent of our present daily use of oil.

The transition period we are entering will thus require major changes in individual as well as social and economic behavior. We are clearly faced with the kinds of difficult choices all societies would rather duck, but ducking is no longer an available option.

26 **Nuclear.** There are problems with nuclear energy, too. Alvin M. Weinberg, director of Oak Ridge Associated Universities' Institute for Energy Analysis, explained the costs and benefits of converting to nuclear energy. Excerpts from a paper he wrote follow.

If we judge from the statistics—68 nuclear reactors supplying 12.5 percent of our electricity in 1978, 200 commercial nuclear reactors powering British, French, Soviet, and American naval vessels—nuclear power is a great success.

But nuclear power is embroiled in a bitter debate that pits those who believe nuclear power is too dangerous against those who insist it can be safely controlled.

Each 1,000-megawatt nuclear power plant can replace an oil-fired plant that burns 8 million barrels of oil per year or a coal-fired plant that burns 2.5 million tons of coal per year. Were we to replace the 300 nuclear plants originally planned for operation by 2000 A.D. with coal-powered plants, we might have to dig an additional 750 million tons of coal annually; if with the oil, we would have to import an additional 2,500 million barrels of oil each year.

With the world in an energy crisis, there is the strongest incentive to use and expand nuclear energy.

But there are potential problems that center on the dangers of intense radioactivity generated in a nuclear power plant, and on the possibility that plutonium produced in a reactor can be used to make nuclear bombs—the proliferation issue.

The possibility of terrorist attack on a nuclear plant or of clandestine diversion of nuclear material must be guarded against. This means that nuclear facilities will always require heavy security.

The security demanded at such sites is a small price to pay for an enormous, new energy source. Moreover, if the sites are permanently dedicated to nuclear activities, both the low-level radioactive wastes and the reactors themselves, after 40 years of operation—the predicted period for which they would be serviceable—could be kept where they are until most of their radioactivity has decayed. The hazards associated with our current practice of transporting radioactive materials away from the site would thus be greatly reduced.

Until the Three Mile Island incident, we in the nuclear community were confident that the probability of such an accident was very small. After all, the world's pressurized water reactors had operated for 500 reactor years without an accident that harmed the public. To this one must add more than 1,000 reactor years of operation by a nuclear navy.

Three Mile Island has shaken this belief. Although no one was hurt, if the probability of such accidents is no lower than 1 in 500 reactor years, the public will probably not accept nuclear energy. The future, indeed the survival of nuclear power requires us to do better. As the Kemeny Commission that investigated Three Mile Island put it, "the legacy of TMI is the need for change."

27 **Other sources.** In addition to coal and nuclear fuels, there remain those "renewable" energy sources. For example, solar energy, geothermal energy, ocean wave action, the wind, and many other energy sources have been discussed as possible alternatives. One alternative which seems especially promising is the use of liquid hydrogen. Clearly, hydrogen is in abundant supply, but the economic feasibility of its use has not been determined.

Sohio's execution committee[1]

28 An executive committee comprising five men exercises the authority of the board of directors during the intervals between board meetings. Those men are A. W. Whitehouse, Jr.; J. D. Harnett; W. J. Delancey; H. Taylor, Jr.; and H. A. Shepard.

Executives

29 Alton W. Whitehouse, Jr. was elected chairman and chief executive officer of Standard Oil of Ohio by the board of directors, effective January 1, 1978. He had served as vice chairman from January 1, 1977 to January 1, 1978.

30 Whitehouse became president of Sohio on January 1, 1970, the same date BP Oil Inc., principal U.S. subsidiary of the British Petroleum Company Limited, merged into Sohio. The merger expanded Sohio's marketing area to the East Coast states and provided the Prudhoe Bay oil field leases in Alaska.

[1] The information in this section was obtained from Sohio headquarters in Cleveland, Ohio.

31 Whitehouse was elected to Sohio's board of directors in 1967 and joined the company the following year as vice president and the company's first chief legal counsel. Previously, he had been a partner in the law firm of Squire, Sanders & Dempsey.

32 Educated in Albany, New York and Charleston, South Carolina, Whitehouse received his law degree from the University of Virginia Law School in 1952. He joined the Cleveland law firm of McAfee, Hanning, Newcomer, Hazlett and Wheeler, becoming a partner in 1960. The firm represented Sohio in various legal matters for years before merging with Squire, Sanders & Dempsey.

33 Whitehouse is active in civic and professional activities and presently is a trustee of Cleveland Clinic Foundation, Case-Western Reserve University, and Cleveland Museum of Art.

34 He is a director of the British Petroleum Company Limited, Cleveland-Cliffs Iron Company, Ameri Trust Corporation, Ferro Corporation, Midland-Ross Corporation, and American Petroleum Institute. Whitehouse is a member of the Conference Board, Highways Users Federation, and is on the executive committee of the Greater Cleveland Growth Association.

35 He is also a member of the Cleveland, Ohio State, and American Bar associations.

36 Joseph D. Harnett, president and chief operating officer of Standard Oil of Ohio, was elected to that post effective January 1, 1977. He had been executive vice president since 1970.

37 Harnett joined Sohio in 1941 as an engineer in the company's transportation department at its headquarters in Cleveland. During his 35-year career with the company he has held a wide variety of assignments.

38 He was elected vice president of Sohio's pipeline subsidiaries in 1950, and was elected vice president in charge of transportation for Sohio in 1957. The following year he was appointed vice president of Sohio's marketing department.

39 Harnett continued in that post until 1968, when he was elected a senior vice president and assumed responsibility for both marketing and refining. In 1968 he also was elected to the board of directors.

40 He has been responsible for Sohio's marketing, refining, supply, and transportation operations since 1970 when he was elected executive vice president. In addition, he served as chairman of the construction committee of the 800-mile trans-Alaska pipeline being built by a consortium of eight companies.

41 Harnett is a native of Nutley, New Jersey, and a 1939 graduate of Purdue University. He is active in civic and professional activities and presently serves on the boards of Cleveland's Marymount Hospital and John Carroll University; is a trustee of University Hospitals of Cleveland; a vice president of the Cleveland Convention and Visitor's Bureau; a director of the American Petroleum Institute; and a member of the president's council of Purdue University.

42 William J. DeLancy was elected chairman of Republic Steel Corporation on February 20, 1979, and continued as chief executive officer. He had been president and chief executive officer since February 19, 1974. An officer of the corporation since 1961, he had been executive vice president since October 20, 1971.

43 He joined Republic Steel on April 14, 1952 as assistant counsel. In 1954, he was named assistant general counsel and five years later advanced to general counsel. He was elected vice president and general counsel on May 10, 1961, and on February 20, 1968, was elected to the board of directors.

44 He came to Republic from the law firm of Cravath, Swaine & Moore in New York.

45 He is director of AmeriTrust Corporation, Standard Oil of Ohio, the Sherwin-Williams Company, the Ohio Bell Telephone Company, Metropolitan Life Insurance Company, Reserve Mining Company, and Beatrice Pocahontas Company. He is also a director or trustee of the Musical Arts Association, University Hospitals, the Cleveland Council on World Affairs, Case-Western Reserve University, the American Iron and Steel Institute, and the International Iron and Steel Institute.

46 Born in Chicago, Illinois on June 2, 1916, DeLancey graduated from Elgin (Illinois) High School in 1934 and from the University of Michigan in 1938. At Michigan, he was elected to Phi Beta Kappa, Phi Eta Sigma, and Phi Kappa Phi, scholastic honor societies. In 1940, he received his law degree from the University of Michigan Law School, where he was editor of the Michigan Law Review and a member of the Order of the Coif, legal honor society.

47 During World War II, he served in the U.S. Navy as an air combat intelligence officer with the rank of lieutenant (junior grade) on the USS Bennington. For his service on the aircraft carrier, he was awarded the commendation ribbon.

48 Hobart Taylor, Jr., a Washington attorney and former executive vice chairman of the president's Committee on Equal Employment Opportunity, was elected to the board of directors of Standard Oil of Ohio on January 26, 1971. He is also a member of Sohio's executive committee. Taylor is counsel to the law firm of Jones, Day, Reavis & Pogue.

49 A native of Texarkana, Texas, Taylor received a bachelor's degree from Prairie View State College, a master's from Howard University, and in 1943 a law degree from the University of Michigan.

50 Since admittance to the Michigan bar in 1944, he has held many important federal government posts in addition to a broad legal and business career. They include special assistant to the vice president of the United States and associate counsel to the president. He was a director of the Export-Import Bank from 1965 to 1968.

51 Prior to his varied service to the federal government, Taylor was a research assistant to the chief justice of the Michigan Supreme Court; assistant prosecutor in Wayne County, Michigan; a corporation counsel; a senior

partner in the Detroit law firm of Taylor, Patrick, Bailer & Lee; and president of the Beneficial Life Insurance Society of Detroit.

52 Taylor is a director of the Great Atlantic & Pacific Tea Co., Westinghouse Electric Corp., Aetna Life & Casualty, Eastern Airlines, Inc., and Burroughs Corporation.

Sohio's products

53 Sohio produces products in three broad areas: petroleum, other minerals, and chemicals and plastics.

Petroleum

54 Due to the magnitude of their domestic oil reserves, Sohio has substantially integrated their petroleum operations. The integrated parts include exploration, production, transportation, refining, and marketing. Exploration for and production of domestic crude oil are the responsibility of Sohio Petroleum Company, a subsidiary of Sohio.

55 **Exploration.** Sohio plans to expand their exploration programs in both onshore and offshore areas. Their long-term exploration goal is "to find and develop new crude oil and gas reserves which will help offset the eventual decline in production at Prudhoe Bay" (1978 annual report). To implement this objective, Sohio plans to acquire lands for exploration. The land can be acquired via bidding for leases, purchase, or agreeing to drill on lands leased by others for a partial interest in any oil or gas discovered.

56 In 1978, Sohio drilled two exploratory wells on the North Slope in conjunction with other oil companies, two more wells were drilled on the North Slope independently by Sohio, and two dry holes were drilled in the Gulf of Mexico on leased land. Also in 1978, two tracts of land were acquired in the Gulf of Mexico near Pensacola, Florida, for a cost of $10.4 million, and another tract was acquired in a lease sale off the Louisiana coast for $7 million. Total exploration expenditures for Sohio in 1978 were $57.6 million. This figure represented an increase of 46.9 percent over 1977 exploration expenditures. Another substantial increase was expected in 1979.

57 **Production.** The cost of producing oil from proven reserves is substantial. In 1978, Sohio's capital expenditures in the Prudhoe Bay area were $312 million. During the next 10 years, their capital expenditures in the area are expected to exceed $4 billion. Contrary to popular belief, maintaining proven reserves is an expensive undertaking. At year-end 1978, there were 188 producing wells in the Prudhoe Bay. This number represents about one third of the wells which will be required to extract the remaining oil from the bay over the next decade. In addition to drilling new wells, pipelines, housing,

and other support systems will be required to efficiently manage the flow of new oil coming from the bay.

58 Sohio's share of the 1978 proven reserves in Alaska amount to 4.1 billion barrels. Sohio's net production rates in Alaska are expected to peak at 700,000 barrels per day. In addition to crude oil, Sohio's 1978 proven reserves of natural gas in Prudhoe Bay were 6.4 trillion cubic feet. Currently, natural gas which comes up with crude oil is being pumped back into the ground for use at a later date.

59 While Prudhoe Bay looks promising for the next decade, Sohio's mature oil fields in the United States are declining. However, technological improvements which enhance recovery from existing wells are expected to offset this decline temporarily. In 1977, Sohio's crude oil and natural gas reserves in the 48 adjacent states were 55.7 million barrels and 265.5 billion cubic feet, respectively. In 1978, their proven reserves in the mainland United States were equal to 52.9 million barrels and 266.8 billion cubic feet, respectively.

60 **Transportation.** The daily volume of crude oil flowing through the trans-Alaskan pipeline to the U.S. mainland from Alaska's North Slope is in excess of 1.5 million barrels. Of this amount, 950,000 barrels per day are used on the West Coast and in Alaska. Sohio has no refineries on the West Coast. However, it places in excess of 500,000 barrels per day on the West Coast either by sale to other domestic refiners or by exchanges with them for crude oil for resale or for use in Sohio's Ohio and Pennsylvania refineries.

61 Sohio has assembled a fleet of tankers to transport North Slope oil to the Gulf Coast and Carribean via the Panama Canal. Their total dead weight tonnage capacity is 3 million. The cost of transporting a barrel of oil to the Gulf Coast or Carribean is $3.75. The difference in the costs of transportation to the two areas can be understood by explaining the process by which crude oil is transported through the Panama Canal.

62 First, oil is transferred from large tankers out of Alaska to super tankers which serve as floating terminals. Second, oil is transferred to smaller tankers capable of canal transit. Third, the oil is delivered to refineries in the Carribean and the Gulf Coast areas. This process is expensive and time consuming. Therefore, Sohio has sought opportunities to build pipelines to transport crude oil from the West Coast to markets east of the Rocky Mountains.

63 In 1973, Sohio began work planning a pipeline (called PACTEX) which would run from Long Beach, California to Midland, Texas. In November 1977, 61 percent of Long Beach voters approved the lease of a terminal site for PACTEX, but the project has been abandoned. In a letter to the author, R. B. Nash, manager of investor relations for Sohio, explained the reason for not continuing with the project:

> Delays caused by waiting for permits and approvals can substantially increase the cost of a proposed project or even kill it. For example, Sohio

devoted over four years of effort and $57 million to plan a west-to-east pipeline from Long Beach, California, to Midland, Texas. Last year, we abandoned this PACTEX project when it became apparent that a battle between two California regulatory agencies and pending lawsuits by special interest groups would delay the plan indefinitely.

64 Sohio has interests in various pipelines such as Mid-Valley and Capline Systems which transport crude oil from the Southwest and the Gulf Coast to the upper Midwest. They also have interests in refined products pipelines such as Colonial Pipeline and Laurel Pipeline.

65 **Refining.** Sohio has three refineries: two in Ohio (Toledo and Lima) and one in Pennsylvania (Marcus Hook). They have combined crude capacity of 452,000 barrels per day. Actual rates for these three facilities are shown in Exhibit 11.

exhibit 11
Refinery product rates for Sohio

	Barrels per day	
	1978	*1977*
Crude oil processed	423,697	426,187
Products refined		
Gasoline	258,459	250,654
Leaded	177,774	187,150
Unleaded	80,685	63,504
Distillates	99,246	106,955
Residuals	47,059	48,739

Source: 1978 annual report

66 **Marketing.** The gasoline marketing strategy employed by Sohio is to reduce their number of outlets while increasing the number of gallons sold per outlet. As a result, the number of retail outlets owned by Sohio declined from about 3,500 to about 2,600 between 1974 and 1978 (these figures do not include outlets owned by independent jobbers).

67 Sohio is a major marketer of gasoline and other refined petroleum products in Ohio. It markets under the Boron, BP, Scot, and William Penn brands in other midwestern and eastern states. Additionally, the company supplies petroleum products for industrial, commercial, governmental, agricultural, and residential needs.

68 In Sohio's marketing areas, there is increased demand for the self-service style of marketing, and the trend is expected to intensify. Therefore, the company is converting many of their retail outlets to accommodate the self-serve customer, but they are maintaining enough full-serve facilities in Ohio to provide for that part of the market. Sohio's marketing capital expenditures in 1978 were $23.3 million. Capital expenditures are expected to be at that level for the next five years.

69 Domestic demand for unleaded gasoline increased by about 30 percent in 1978 while total gasoline demand increased by only 3 percent. As demand for

unleaded gasoline increased, the U.S. government moved to eliminate the use of MMT, an additive used to increase octane ratings of unleaded fuels. The result is to require more intense refining to meet the octane level requirements of today's automobiles. Sohio recognizes the increased demand for unleaded and leaded fuels, but the company cannot justify increasing refining capacity at this time. The following is an excerpt from their 1978 annual report:

> The Department of Energy is continuing to enforce outmoded and unrealistic price regulations that do not provide even the minimum incentive to produce more gasoline. Therefore, no new major refineries are presently being built in the United States, principally because of these government regulations that do not allow adequate return on such investment, and because of environmental restrictions.
>
> Even potential improvements to existing refineries that could significantly improve overall gasoline production are not being made because of price regulations. As long as these regulations fail to recognize that the cost of refining is not equally distributed to all products, but is disproportionately associated with gasoline production, the industry's ability to satisfy consumer demand for gasoline will be severely tested. Price increases were made on all products during 1978, but Sohio was unable to recover fully the actual increased costs of crude oil and refining.

70 There is another significant marketing difficulty with which Sohio must deal. There is movement to force petroleum producers to divest themselves of their retail operations. There are proposals to create such legislation in 17 states, and Maryland and Delaware already have similar legislation in effect. As of 1978, no state in which Sohio does business has passed such legislation. Sohio is opposed to legislation attempting to force divestiture on major oil producers. The adverse effects of this legislation would be to reduce competition at the retail level and, in the long run, reduce the quality of service to ultimate consumers.

Other minerals

71 **Coal.** Sohio's coal division is the Old Ben Coal Company. They produce bituminous coal which is obtained from surface and underground mines in Indiana and Illinois. Their contribution to Sohio's 1978 operating income was \$3.2 million, down from \$27.5 million in 1977. The poor results in 1978 were due largely to the nationwide United Mine Workers strike which caused Sohio a \$10.7 million loss in the first quarter of 1978. Coal production in 1978 was 7.8 million tons, down from 9.7 million tons in 1977.

72 In 1978, Sohio increased its coal reserves with the purchase of 80 million tons in Pennsylvania. Additionally, Old Ben sank a new, deep mine in 1978. Sohio's total year-end 1978 coal reserves were estimated at 923 million tons. Of this total, 275 million tons is under production by Old Ben, 271 million

tons is not assigned to a division, and the economic feasibility of the remainder has, as yet, not been determined.

73 **Uranium.** Sohio owns a share of the L-Bar uranium mine and mill near Albuquerque, New Mexico. Their share of production in 1978 was 276,000 pounds of uranium oxide. This total represents a 73,000-pound increase over their 1977 share.

74 **Oil shale.** Sohio has an interest in the Paraho Oil Shale Development Project in Colorado. To date, their activity with the project has amounted to refining about 70,000 barrels of shale oil for the U.S. Navy. Sohio's shale oil activity is dependent to a large extent on government actions to stimulate investment in alternate energy sources.

Chemicals and plastics

75 A wholly owned subsidiary of Sohio, Vistron Corporation produces agricultural and industrial chemicals, fabricated plastic products, and fiberglass reinforced plastic panels. Vistron's sales in 1978 were $327.7 million, up from $314.9 million in 1977. But operating income fell from $31.2 million to $19.7 million between 1977 and 1978. This decline was attributed in part to lower margins in ammonia and ammonia derivatives caused by the rising price of natural gas. The cost increases could not be recovered due to the highly competitive nature of the markets in which Sohio's products are sold.

76 Because of excess production capacity in ammonia, a significant number of U.S. plants were permanently closed in 1978 and several were shut down temporarily for maintenance. The result of these actions is to reduce ammonia inventories and capacity. The demand for fertilizer, of which ammonia is a key ingredient, continues to grow. Sohio plans to vertically integrate their agricultural chemical operation forward to improve their service to agricultural customers. They currently have 116 Sohigro Service Company bulk blend plants.

77 Vistron's industrial chemical sales were $126.5 million in 1978, up from $123.6 million in 1977. They are the largest supplier of acrylonitrile to the merchant market in the United States. Acrylonitrile is a basic raw material used in acrylic fibers. Additionally, it is used in high-impact plastic resins. Vistron discovered acrylonitrile and markets it throughout the world. The company intends to continue to increase production of acrylonitrile to meet expected increases in demand.

78 Exhibit 12 shows a financial breakdown for Sohio by business segment.

Sohio and the U.S. government

79 Government involvement in the oil industry, and energy areas in general, is inevitable because energy is such a vital ingredient in the well-being of our

exhibit 12
Business segment information ($000)

				Unaudited	
	1978	*1977*	*1976*	*1975*	*1974*
Sales and operating revenue					
Petroleum	4,688,748	$3,028,758	$2,443,758	$2,037,480	$1,788,469
Other minerals	175,753	167,422	150,014	166,270	114,680
Chemicals and plastics	327,728	314,883	317,924	280,411	263,028
Royalties from licenses on patented processes	5,485	12,160	4,724	22,975	41,012
	5,197,714	3,523,223	2,916,420	2,507,136	2,207,189
Income before interest, income taxes, and extraordinary item					
Petroleum	1,102,621	426,273	155,606	84,216	72,515
Other minerals	8,929	29,644	30,418	49,368	29,473
Chemicals and plastics	19,719	31,172	46,923	54,162	47,895
Royalties, corporate, and other	(1,141)	5,982	2,422	19,081	43,075
	1,130,128	493,071	235,369	206,827	192,958
Assets					
Petroleum	7,705,160	7,190,748	5,704,777	3,723,623	2,148,205
Other minerals	273,740	223,208	208,838	172,115	130,565
Chemicals and plastics	181,064	163,641	185,916	178,798	145,150
Royalties, corporate, and other	166,103	200,408	160,687	145,907	197,564
	8,326,067	7,778,005	6,260,218	4,220,443	2,621,484
Capital expenditures					
Petroleum	704,263	1,041,015	1,639,152	1,571,896	666,625
Other minerals	40,920	34,124	42,992	46,678	23,483
Chemicals and plastics	13,978	9,198	13,373	19,258	8,465
Corporate and other	3,090	2,742	3,282	3,783	1,839
	762,251	1,087,079	1,698,799	1,641,615	700,412
Depreciation depletion, and amortization expense					
Petroleum	372,747	140,397	58,012	63,561	51,710
Other minerals	16,027	13,221	9,871	7,475	5,911
Chemicals and plastics	14,338	13,685	12,097	10,112	9,690
Corporate and other	2.332	2,070	1,534	1,344	1,123
	405,444	169,373	81,514	82,492	68,434

Source: 1978 annual report.

nation. For years, top management at Sohio has sought government understanding and action. Excerpts from Sohio's annual reports between 1974 and 1978 help explain their position.

Energy policy is needed
We continue to be concerned about the slowness of development of a national energy policy which would encourage private enterprise to make major investments to increase production from traditional sources of energy.

In addition to a national energy policy, the federal government must provide a stable climate in which investors can plan long-range investments.

It also must create incentives and financial aid for the development of new, high-risk technology for extracting energy from oil shale and tar sands and to obtain clean fuels from coal. The lack of suitable government support has caused our Old Ben Coal Company division to shelve plans to construct a prototype coal conversion plant. We are encouraged by our experience with the oil shale technology that we are testing, dut we continue to be concerned about the impact of inflation and environmental requirements upon costs, the availability of water, and the time that may have to pass before shale investments produce a return.

We welcome President Ford's proposed legislation to postpone certain air emission standards and to permit greater use of coal for power plants and industrial uses. Plants now burning scarce natural gas must be converted to coal. We also welcome the president's proposal of legislation to postpone application of rigorous auto exhaust pollution standards for five years in order to obtain improved gasoline mileage. This country should balance its environmental needs with economic needs. It should measure the economic impact of environmental proposals before decisions are made.

Action of some kind on the nation's energy problems will be taken in Washington this year. It is imperative that thinking, concerned people—particularly those with some knowledge of the energy industries—express to their elected representatives their views with respect to conservation of energy and the encouragement of additional supplies. We urge you to make your views known.

The energy industries are handicapped by governmental restriction and regulations, by the threat of adverse legislation presently being considered by the Congress, and by the uncertainties spawned by the troubled economic conditions in much of the world.

[1974 annual report]

Politics and energy

We have reported to you what Sohio is doing to develop its energy resources—resources which will represent a significant addition to this nation's energy supplies.

Contrast our efforts in Alaska with the criticism the oil industry has received in the press and from certain politicians. Politicians seeking to capitalize on public dissatisfaction with higher petroleum prices have accused Sohio of profiteering on gasoline at times when our entire marketing and refining operations were operating either at a loss or, as in 1975, achieving essentially break-even results.

Such political opportunism has had the unfortunate effect of denying the public an understanding of the complex economic and regulatory forces that affect the petroleum industry today.

While Sohio has been working to bring Alaskan oil to market in the United States and others in the industry have been seeking to develop offshore and other domestic oil resources, all have been handicapped and continuously harrassed by government legislation and threats of more legislation.

Consider some of the legislation enacted. With the nation already dependent upon imports for more than 35 percent of its petroleum needs,

Congress specifically eliminated statutory depletion allowances for oil but not for any other natural resource. Only a few in government faced up to the fact that the elimination of the depletion allowances coupled with the continuation of petroleum price controls would reduce petroleum income and capital available to the oil and gas industry by more than $100 billion in the next 10 years.

Then in December the Energy Policy and Conservation Act of 1975 was enacted, extending price controls for the oil industry—but for no other industry. Controls are extended in a way that virtually assures annual direct involvement by both the president and Congress in determining specific petroleum prices. The forces of the marketplace have worked very well over many years in making these determinations. The substitution of government intervention and regulation for competitive market forces can only lead to more shortages and higher costs.

Supply problems for natural gas seem likely to become even more acute if legislation recently passed by the House of Representatives becomes law. This legislation would continue price controls on most natural gas and would extend controls to much of the presently unregulated natural gas.

More extreme legislation also has been introduced in Congress. The threat of this punitive legislation has been a disturbing factor to investors and to lenders who know that an increase in oil and gas development is needed. It is reasonable to expect that responsible leaders in the nation will not jeopardize the economic future and security of the country by further handicapping the industry that must develop these resources. However, proposals before Congress and statements by many prominent politicians raise concerns as to whether responsible leadership will prevail.

Proposals to break up the nation's major oil companies failed by less than 15 votes in the U.S. Senate three times in 1975. Some such proposals would forbid oil companies from participating in development of other energy resources such as coal, shale, or uranium. Others would break up oil companies vertically—separate marketing, refining, transportation, and oil-production operations into separate companies. Supporters of that legislation have no proof or basis of assurance that the scattered pieces of the industry could generate or obtain the capital needed to meet today's challenge for greater domestic energy supplies. The threat of such drastic economic experiments comes at the very time greater investment is urgently needed to increase domestic energy production.

The political climate also is greatly inhibiting oil industry management's ability to make timely decisions on future investments of all kinds. The recent drop in demand for petroleum products is temporarily masking the damage that is being done. For example, in three to five years we could again be faced with a serious shortage of domestic refining capacity.

Recent proposals by Alaskan legislators of extreme taxes on oil profits are another example of the type of legislative threat that shakes the confidence of investors.

Internationally, oil has become a weapon in world power struggles. In our own country the oil industry has become a focal point of politics. We have not been able to prevent this involvement with politics, but all of us in the oil industry have been speaking up for and defending our industry

against attacks that seem designed to hamper it in developing greater domestic energy resources.

[1975 annual report]

Greater public awareness of the energy problem, plus the legislative and executive branches of the federal government being controlled by the same political party, should make the development of an energy policy possible. Such an energy policy will require wide public support because some difficult and unpopular decisions are needed.

[1976 annual report]

The oil industry, as is well known, has long been international in scope. Unfortunately, oil today has become an instrument of international policy and power politics by some nations. Under these circumstances, U.S. government intervention in industry affairs to protect legitimate national interest is inevitable. It can only be hoped that government's role will be helpful rather than counterproductive.

On the domestic scene, the industry continues to be caught between the advocates of abundant low-cost energy on the one hand, and those favoring "no growth" philosophies on the other. This situation is not likely to be changed by pending legislation. Ill-advised proposals and patchwork regulations, if enacted, could needlessly penalize the entire industry, deter needed investments, and jeopardize the industry's ability to meet America's future energy needs.

[1977 annual report]

The role of government with respect to the petroleum industry, of course, has been substantial for many years. Some of this involvement has encouraged energy development; however, in recent years the role of government has become increasingly restrictive. The imposition of price controls since 1971; proliferation of environmental regulations (with little or no regard for their merits on a cost/benefit basis); frequent delays in federal and state offshore leasing schedules; a land freeze in Alaska and other land use limitations; frequent tax increases on energy production in Alaska and in some other states; and allocation and export-exchange regulations all have caused investment distortions and planning uncertainty.

Furthermore, punitive legislation is threatened which would tear the petroleum industry apart or prohibit its participation in the development of more than one energy source. The threat of this legislation is real, in spite of its being based upon the faulty and unsubstantiated assumption that the petroleum industry today is not competitive. This divestiture legislation, if enacted, would probably result in less productivity, because the flow of capital within the industry would be disrupted.

[1978 annual report]

Research and development

80 Sohio's research and development activities center around commercialization of new chemical processes and materials for their use, and possibly for

use in the future by others who will purchase licenses. Currently, the emphasis is shifting toward developing alternative energy sources.

81 An example of such activity is a joint undertaking by Sohio and TRW, Incorporated. Together they plan to develop a process for producing synthetic gas and electricity from coal and other combustible materials. It is anticipated that a pilot plant will be set up in the near future to continue the project, and that commercial operations can begin by the late 1980s.

82 Sohio's R&D expenditures in 1978 were $15.1 million up $3.4 million from 1977. Sohio plans to devote more resources to R&D in the future.

Financial matters at Sohio

83 Exhibits 13 through 19 present relevant financial data for Sohio.

Sohio's future

84 At least for the next decade, Sohio is in the enviable position of having enough crude oil to meet its own needs. Therefore, decisions made during the coming decade will be crucial ones. According to *The Wall Street Journal* (January 12, 1980),

> The oil is flowing out of Alaska now, of course. And, after years of a hand-to-mouth existence, Sohio suddenly finds itself with an enviable problem: With few existing operations to absorb cash, how should it spend profits that currently run more than $1 billion a year?
>
> "I don't think there's any corporation in America with the ability to control its future to the extent we can," says Glenn Brown, senior vice president for corporate planning, "The sky's the limit as to what we can do, because we don't have a lot of imbedded investments to protect."
>
> But Sohio needs to buy wisely: The company runs the risk of watching its assets shrink again when the North Slope begins to dry up.
>
> Now Sohio plans to branch out. In spending its North Slope riches, it will invest in an assortment of projects that primarily have to do with energy. It will expand coal production, work on coal gasification and shale-oil development, and put money into such exotic processes as nuclear fusion by laser beam. The company also will move heavily into exploration for oil and gas in the United States.
>
> It is a spending strategy that should prove politically palatable, given the U.S. dependence on precarious foreign oil and the fuss in Washington when oil companies invest in nonenergy businesses. "We expect energy to be the primary thrust of the 1980s," says Alton Whitehouse Jr., chairman and chief executive. "We think about diversification but have no hard plans."
>
> The emphasis in Sohio's energy drive, for now at least, is oil and gas exploration. In November, the company won an exploration tract in the Gulf of Mexico with a bid of $70 million. The following month it completed a $145 million acquisition of two Denver companies, gaining access to 1.5

exhibit 13

THE STANDARD OIL COMPANY (OHIO)
Statement of Income and Retained Earnings
For the Years Ended December 31, 1974–1977
($000)

Income	*1978*	*1977*	*1976*	*1975*	*1974*
Revenues:					
Sales and operating revenue (excluding excise taxes)	$5,197,714	$3,523,223	$2,916,420	$2,507,136	$2,207,189
Gain on asset sales, equity, and other income	12,614	44,347	10,341	13,954	13,416
Total revenues	5,210,328	3,567,570	2,926,761	2,521,090	2,220,605
Costs and expenses:					
Crude oil, products, merchandise and material costs, and operating expenses	3,050,733	2,467,349	2,273,257	1,840,183	1,675,845
Selling, general and administrative expenses	337,998	300,271	270,511	252,195	234,725
Taxes other than income taxes	286,025	137,506	66,110	139,393	48,643
Depreciation, depletion, and amortization	405,444	169,373	81,514	82,492	68,434
Total costs and expenses	4,080,200	3,074,499	2,691,392	2,314,263	2,027,647
Income before interest, income taxes, and extraordinary item	1,130,128	493,071	235,369	206,827	192,958
Interest					
Incurred	487,084	435,901	258,202	121,987	61,905
Capitalized or deferred	(7,608)	(181,980)	(209,404)	(95,288)	(43,305)
Income	(21,553)	(8,002)	(6,286)	(6,828)	(11,653)
	457,923	245,919	42,512	19,871	6,947
Income before income taxes and extraordinary item	672,205	247,152	192,857	186,956	186,011
Income taxes applicable to income before extraordinary item—Note 1	222,000	66,100	56,000	60,400	60,100
Income before extraordinary item	450,205	181,052	136,857	126,556	125,911
Extraordinary item	0	0	0	0	21,600
Net income	$ 450,205	$ 181,052	$ 136,857	$ 126,556	$ 147,511
Earnings per share of common stock*					
Income before extraordinary item	$4.00	$2.19	$1.77	$1.71	$1.72
Net income	4.00	2.19	1.77	1.71	2.01
Cash dividends	.83	.68	.68	.68	.68
Retained earnings					
January 1	$ 824,981	$ 698,523	$ 614,498	$ 538,406	$ 428,383
Net income	450,205	181,052	136,857	126,556	147,511
Cash dividends:					
Common	(49,721)	(40,405)	(40,276)	(37,896)	(37,062)
Special (per share, 1978—$40,520.28; 1977—$13,804.68)	(40,520)	(13,805)	(12,148)	(12,148)	0
Preferred (per share, Series A—$3.75; Series B—$4)	(353)	(384)	(408)	(420)	(426)
Retained earnings, December 31	$1,184,592	$ 824,981	$ 698,523	$ 614,498	$ 538,406

*Adjusted for two-for-one common stock split in 1978.
The notes to financial statement (Exhibit 14) are an integral part of these statements.

exhibit 14

Note to financial statements

Note 1—Federal, foreign, and state income taxes (000s)

	1978	1977
Current—Federal	$ 8,959	$ 1,298
Foreign	5,077	14,974
State	78,400	3,500
	92,436	19,772
Deferred—Federal	264,236	92,781
Investment credit	(134,672)	(46,453)
	129,564	46,328
Income tax expense	$222,000	$66,100

Investment credit is recognized on the flow-through method including carryforwards of $260,939 (expiring 1981–1985) available at December 31, 1978 to reduce future taxes payable. In addition, $187,138 of unrecognized investment credit is available to reduce taxes for financial and tax purposes—$146,720 expiring in 1984 and $40,418 expiring in 1985.

Deferred taxes, before investment credit, were provided for timing differences between financial and taxable income as follows:

	1978	1977
Interest capitalized	$ 1,877	$ 69,152
Interest deferred	(12,300)	(4,260)
Intangible drilling and other related costs	25,959	33,248
Prepaid Alaskan severance tax	(33,364)	57,418
Depreciation	84,463	172,373
Deferred taxes not provided due to tax loss	0	(270,016)
Utilization of tax loss carryforward	193,034	0
Other	4,567	34,866
	$264,236	$ 92,781

The income tax expense on pretax earnings of $672,205 in 1978 and $247,152 in 1977 was less than the normal federal corporate tax because of the following:

	1978	
Normal federal corporate tax	$322,658	48%
Effect of:		
Investment credit	(134,672)	(20)
State income taxes	40,768	6
Excess of statutory over cost depletion	(5,779)	(1)
Foreign income subject to U.S. taxation in addition to foreign taxation	2,640	1
Other	(3,615)	(1)
Income tax expense and effective rate	$222,000	33%

	1977	
Normal federal corporate tax	$118,633	48%
Effect of:		
Investment credit	(46,453)	(19)
Excess of statutory over cost depletion	(6,726)	(3)
Foreign income subject to U.S. taxation in addition to foreign taxation	7,786	3
Capital gains rate	(6,485)	(2)
Other	(655)	—
Income tax expense and effective rate	$ 66,100	27%

At December 31, 1978, the company had net operating loss carryforwards of approximately $390 million, arising from timing differences, which expire in 1984 and are available to reduce future taxable income, but will have no impact on financial income.

Source: 1978 annual report.

exhibit 15
Financial statistics ($000)

	1978	*1977*	*1976*	*1975*	*1974*
Financial position—year-end					
Current assets	$1,882,907	$1,557,843	$1,050,424	$ 685,157	$ 670,657
Other assets	347,037	463,479	340,698	254,004	203,579
Property, plant, and equipment—net	6,096,123	5,756,683	4,869,096	3,281,282	1,747,248
Total assets	$8,326,067	$7,778,005	$6,260,218	$4,220,443	$2,621,484
Current liabilities	$1,346,368	$ 997,196	$ 652,684	$ 453,110	$ 350,987
Other liabilities	94,315	45,591	36,231	32,396	19,602
Long-term debt	4,016,161	4,504,360	3,585,345	1,911,273	767,043
Long-term lease obligations	381,474	183,205	41,502	37,900	37,900
Deferred revenue	163,364	213,674	287,206	252,570	155,618
Deferred income taxes	283,840	154,276	107,948	71,915	46,740
Stockholders' equity	2,040,545	1,679,703	1,549,302	1,461,279	1,243,594
Total liabilities	$8,326,067	$7,778,005	$6,260,218	$4,220,443	$2,621,484
Working capital	$ 536,539	$ 560,647	$ 397,740	$ 232,047	$ 319,670
Ratio of current assets to current liabilities	1.40	1.56	1.61	1.51	1.91
Debt to borrowed and invested capital (percent)	68	74	71	59	43
Operating results:					
Sales and operating revenue	$5,197,714	$3,523,223	$2,916,420	$2,507,136	$2,207,189
Net income	450,205	181,052	136,857	126,556	147,511
Dividends paid	90,594	54,594	52,832	50,464	37,488
Net income per sales dollar (cents)	8.7	5.1	4.7	5.0	6.7
Rate of return on borrowed and invested capital (percent)	9.9	4.9	3.6	5.2	8.9
Ratio of earnings to fixed charges	2.28	1.55	1.78	2.54	3.84
Per share of common stock*:					
Net income	$ 4.00	$ 2.19	$ 1.77	$ 1.71	$ 2.01
Dividends paid	.83	.68	.68	.68	.68
Market price-high-low	44-29	46-34	41-31	43-22	43-19
Other data:					
Average number of shares outstanding (000)*	112,510	82,618	76,970	73,726	73,032
Shares outstanding at year-end (000)*	120,018	95,240	77,120	76,868	72,458
Wages, salaries, and employee benefits	431,998	356,763	316,232	273,565	231,783
Research and development expenditures	15,052	11,709	10,498	9,272	7,320

*Based on common stock and equivalents adjusted for two-for-one common stock split in 1978.

exhibit 15 ***(concluded)***

	1978	*1977*	*1976*	*1975*	*1974*
Changes in financial position:					
Sources of working capital:					
Operations	$1,040,314	$ 408,633	$ 268,491	$ 242,818	$ 230,128
Addition to long-term debt, capitalized lease obligations, and deferred revenue	289,705	1,107,726	1,827,915	1,237,639	477,567
Reduction of prepaid Alaskan severance tax	74,086	67,262	20,990	0	0
Decrease (increase) in long-term receivables and advances—net	61,102	(49,179)	20,327	8,736	18,659
Sales of property, plant, and equipment	10,313	21,831	10,696	15,018	14,210
Reduction of deposits under tanker construction contracts	150	263,787	114,231	0	0
Sales of common stock	1,002	4,323	3,859	141,448	1,974
Total sources of working capital	1,476,672	1,824,383	2,266,509	1,645,659	742,538
Uses of working capital:					
Additions to property, plant, and equipment	762,251	1,087,079	1,698,799	1,641,615	700,412
Reduction of long-term debt, capitalized lease obligations, and deferred revenue	629,945	104,690	131,942	19,980	7,748
Dividends paid	90,594	54,594	52,832	50,464	37,488
Addition to deposits under tanker construction contracts	0	230,965	93,753	41,978	7,995
Prepayment of Alaskan severance tax	0	140,611	121,280	0	0
Other transactions—net	17,990	43,537	2,210	(20,755)	12,371
Total uses of working capital	1,500,780	1,661,476	2,100,816	1,733,282	766,014
Working capital (decrease) increase	$ (24,108)	$ 162,907	$ 165,693	$ (87,623)	$(23,476)
Expenditures for property, plant, and equipment:					
Petroleum					
Production	$ 378,931	$ 429,114	$ 549,017	$ 427,778	$ 144,557
Transportation	228,843	571,743	1,053,965	1,070,972	370,393
Refining	13,196	15,334	15,746	47,331	132,719
Marketing	23,293	24,824	20,424	25,815	18,956
Other minerals	40,920	34,124	42,992	46,678	23,483
Chemicals and plastics	13,978	9,198	13,373	19,258	8,465
Corporate	3,090	2,742	3,282	3,783	1,839
Total expenditures for property, plant, and equipment	$ 762,251	$1,087,079	$1,698,799	$1,641,615	$ 700,412
Working capital provided from operations to expenditures for property, plant, equipment	136.5%	37.6%	15.8%	14.8%	32.9%

exhibit 16
Operating and other statistics

	1978	1977	1976	1975	1974
Petroleum					
Net production of crude oil—(barrels per day)					
Alaska	506,815	143,831	0	0	0
United States—except Alaska	21,587	23,477	25,479	27,617	29,646
Iran tanker liftings	6,480	16,041	16,448	21,984	21,910
	534,882	183,349	41,927	49,601	51,556
Net production of natural gas (000 cubic feet per day)	83,196	85,947	79,369	89,549	110,414
Crude oil refinery runs (barrels per day)	423,697	426,187	405,197	364,436	323,336
Crude oil refinery capacity, year end (barrels per calendar day)	452,000	452,000	449,000	431,000	431,000
Petroleum product sales (barrels per day)					
Gasoline	263,662	245,630	247,328	216,492	191,061
Distillates	101,774	103,869	100,276	91,019	102,249
Residuals	50,383	48,101	45,596	35,205	29,153
Other	11,075	8,951	9,306	8,402	10,533
	426,894	406,551	402,506	351,118	332,996
Marketing retail outlets*	2,600	2,800	3,100	3,300	3,500
Other					
Coal produced (000 tons)	7,773	9,718	9,723	9,233	9,450
Acrylonitrile sold (millions of pounds)	409	348	354	251	290
Ammonia produced (000 tons)	447	396	403	385	393
Sales of industrial and wholesale nitrogen (000 tons, ammonia equivalent)	209	204	189	154	204
Retail sales of fertilizer materials (000 tons)	581	479	559	499	448
Number of shareholders of common stock at year-end	41,297	39,850	39,716	40,125	39,536
Employees at year-end	24,145	22,146	21,062	20,550	20,300

*Excludes outlets supplies by jobbers, automobile dealers, marine dealers, etc.
Source: 1978 annual report.

million acres in the Rocky Mountain area. Also in December, Sohio successfully bid for interests in nine blocks in the Beaufort Sea, off Alaska, although the awarding of those leases has been stalled on environmental grounds.

"We'll be looking aggressively at federal and state lease sales throughout the country," says Joseph Harnett, the company's president.

85 Alton Whitehouse expressed optimism in his letter to the shareholders published in Sohio's 1978 annual report. He said,

> Despite considerable planning uncertainty caused by federal and state policies, either in existence or proposed, we still believe that the government will ultimately recognize the importance of a strong and viable energy industry. Consequently, Sohio is developing plans to reinvest much of the

exhibit 17
Per share data ($)

Year end December 31	*1978*	*1977*	*1976*	*1975*	*1974*	*1973*	*1972*	*1971*	*1970*	*1969*[1]
Book value	16.93	17.54	19.95	18.87	17.01	15.49	14.76	14.33	4.04	3.57
Earnings[2]	4.00	2.18	1.77[3]	1.71[3]	1.72	1.01	0.82[3]	0.81	0.89	0.71
Dividends	0.83	0.68	0.68	0.68	0.68	0.67⅝	0.67½	0.67½	0.67½	0.67½
Payout ratio	22%	36%	38%	41%	39%	66%	82%	83%	75%	94%
Prices—High	43½	45⅝	40⅜	42⅝	43	42¾	24⅝	23	21¼	30⅞
Low	28⅛	34½	30¾	22¼	18⅞	21⅛	15	17½	12¾	16¼
P/E ratio	11–7	21–16	23–17	25–13	25–11	42–21	30–18	28–22	24–14	42–23

Note: Data as originally reported. Adjusted for stock dividend(s) of 100 percent July 1978, 100 percent December 1973.
[1]Reflects merger or acquisition.
[2]Before specific item(s) of +0.30 in 1974, +0.21 in 1973, −0.03 in 1972, −0.06 in 1971, +0.06 in 1970.
[3]Fully diluted: 1.76 in 1976, 1.70 in 1975, 0.81 in 1972, 0.89 in 1970.
Source: Standard NYSE stock reports, vol. 46, no. 223, sec. 23. Copyright © 1979 Standard & Poor's Corporation. All rights reserved, November 15, 1979. Standard & Poor's Corp., 25 Broadway, NY, NY 10004.

exhibit 18

Balance sheet data ($ million)

December 31	*Cash*	*Assets*	*Current Liabilities*	*Ratio*	*Total assets*	*Return on assets*	*Long-term debt*	*Com-mon equity*	*Total capital*	*Percent long-term debt of capital*	*Return on equity*
1978	417	1,883	1,346	1.4	8,326	5.0%	4,398	2,032	6,722	65.4%	21.8%
1977	188	1,558	997	1.6	7,778	2.3	4,688	1,670	6,522	71.9	10.1
1976	165	841	540	1.6	6,260	2.6	3,627	1,539	5,284	68.6	9.1
1975	84	656	450	1.5	4,220	3.6	1,949	1,450	3,482	56.0	9.1
1974	118	642	341	1.9	2,621	5.5	805	1,232	2,095	38.4	10.7
1973	153	610	283	2.2	1,963	3.9	414	1,120	1,589	26.0	6.7
1972	57	505	225	2.2	1,802	3.3	405	1,062	1,504	26.9	5.7
1971	55	496	203	2.4	1,815	3.3	494	1,028	1,551	31.8	5.7
1970	60	507	216	2.3	1,747	3.9	500	1,002	1,531	32.6	6.5
1969[1]	86	469	317	1.5	1,554	4.0	252	962	1,237	20.4	6.2

Data as originally reported.

[1]Reflects merger or acquisition; revisions includes other income.

[2]Indicates other income.

[3]Includes equity in earnings of nonconsolidated subsidiaries.

[4]Before specific item(s) in 1974, 1973, 1972, 1971, 1970.

Source: Standard NYSE stock reports, vol. 46, no. 223, sec. 23. Copyright © 1979 Standard & Poor's Corporation. All rights reserved, November 15, 1979. Standard & Poor's Corp., 25 Broadway, NY, NY 10004.

exhibit 19

Income data ($ millions)

Year ended December 31	Revenues	Operating income	Percent operating income of revenues	Capital expense	Depreciation	Interest expense	Net before taxes	Effective tax rate	Net[4] income	Percent net income of revenues
1978	5,192	1,517	29.2%	762	405	487	672[3]	33.0%	450	8.7%
1977	3,511	606	17.3	1,104	169	436	247[3]	26.7	181	5.2
1976	2,912	302	10.4	1,699	82	258	193[3]	29.0	137	4.7
1975	2,484	252	10.2	1,642	82	122	187[3]	32.3	127	5.1
1974	2,166	207	9.6	700	68	62	186[3]	32.3	126	5.8
1973	1,482	154	10.4	193	67	32	108[3]	31.4	74	5.0
1972	1,447[2]	164	11.3	124	71	25	80	25.8	60	4.1
1971	1,394[2]	153	11.0	175	73	29	65	9.6	59	4.2
1970	1,374[2]	152	11.1	243	67	28	67	3.2	64	4.7
1969[1]	1,216	154	12.7	212	55	16	100	47.9	52	4.3

Data as originally reported.

[1]Reflects merger or acquisition; revisions includes other income.

[2]Includes other income.

[3]Includes equity in earnings of nonconsolidated subsidiaries.

[4]Before specific item(s) in 1974, 1973, 1972, 1971, 1970.

Source: Standard NYSE Stock Reports, vol. 46, no. 223, sec. 23. Copyright © 1979 Standard & Poor's Corporation. All rights reserved, November 15, 1979. Standard & Poor's Corp., 25 Broadway, NY, NY 10004.

cash generated by its Alaskan investment in energy-related programs and projects. These include increasing production, improving the profitability of our refining and marketing operations, and investing in further chemical expansion.

However, Sohio intends to develop contingency plans to pursue alternate strategies that include diversification, if the economic or political environment becomes unduly hostile.

Our plans also provide for retiring debt and improving our financial position in order to give us flexibility to invest in energy or other businesses in a changing business environment. We also plan to increase dividends to shareholders periodically, in keeping with our stated long-range objective of increasing our payout ratio.

section C

Strategic internal environment

case 9

Bloomingdale's

1 "Bloomingdale's is a singular enterprise in many respects—not the least of which is that it is usually mentioned in contentious superlatives. The most talked-about department store these days, Bloomingdale's is discussed as though it were human. Its nickname, Bloomie's, strikes some as a triumph of customer identification.

2 "New Yorkers speak passionately about Bloomie's. They love its liberality with shopping bags (it gave away 7 million last year, more than any other store) and merchandise return policy."[1] But the big attraction is the merchandise—thousands upon thousands of items chosen in part for high style and displayed with show business flair." As one famous customer raved, "It's the obvious place to go for everything. Oh gosh, it's the most fantastic and exhausting store in the world."[2]

3 "Bloomingdale's is not the largest department store, but its influence can be enormous. If European-accented country furniture and glass and steel tables have become national decorative cliches, it is because Barbara D'Arcy, director of store design, pioneered and pushed them in her lavish model room settings in the 60s."[3]

4 Bloomingdale's claims to have one of the highest growth rates and net profit margins of any department store in New York City, although it does not publish any financial statements (see Exhibit 1). Bloomingdale's main store at 1000 Third Avenue in Manhattan also claims to have the highest

---

This case was prepared by John P. Dory of New York University.

[1] Marylin Bender, "Bloomingdale's and Its Customers—Dancing Chic to Chic," *New York Times*, September 8, 1974, sec. 3, p. 1 ff.

[2] Leading toward a Green Christmas," *Time*, December 1, 1975, pp. 74–80.

[3] Bender, "Bloomingdale's."

exhibit 1
Bloomingdale's exceptional profit margins*

Following the tight-lipped tradition of its corporate parent, Federated Department Stores, Inc., Bloomingdale's has always buttoned up its financial figures. Recently, however, Lawrence Lachman, the chairman, said that Bloomingdale's sales have been "running at $300 million" for the fiscal year that ends next January 31 [1975].

Marvin S. Traub, Bloomingdale's president, boasts that the company extracts $300 per square foot of selling space at the 59th Street site, which has about 450,000 square feet. With $135 million of indicated sales in the main store, Lachman describes it as "the healthiest downtown business in the United States." Such figures would mean slightly more than half the revenues come from the six branches in the New York suburbs and the four home furnishings specialty stores on Long Island, in Westchester County, and in the suburbs of Philadelphia and Boston.

How profitable is Bloomingdale's? Lachman, almost testily, refuses to elaborate. But Ralph Lazarus, Federated's chairman, has said that Bloomingdale's "produces a better than average Federated profit and growth performance." Last year Federated's department and specialty stores reaped more than 10.5 percent of their sales as pretax profits, a slight shrinkage during the last five years from the 11 percent of 1969. Joseph Ellis, the Goldman, Sachs & Co. analyst, says that 6 to 7 percent is a typical department store profit margin and that "any store that does 10 to 13 percent pretax is in a rarefied area."

* This material originally appeared as part of Marylin Bender's article, "Bloomingdale's and Its Customers—Dancing Chic to Chic," *New York Times*, September 8, 1974, sec. 3, p. 1 ff. The conjecture in these paragraphs has been neither confirmed nor denied by the Bloomingdale's management. Its appearance here does not indicate management's endorsement of its contents.

dollar sales per square foot of any department store in the United States. Part of this performance was the result of Bloomingdale's higher dollar sales per transaction than other department stores, but other factors were also important.

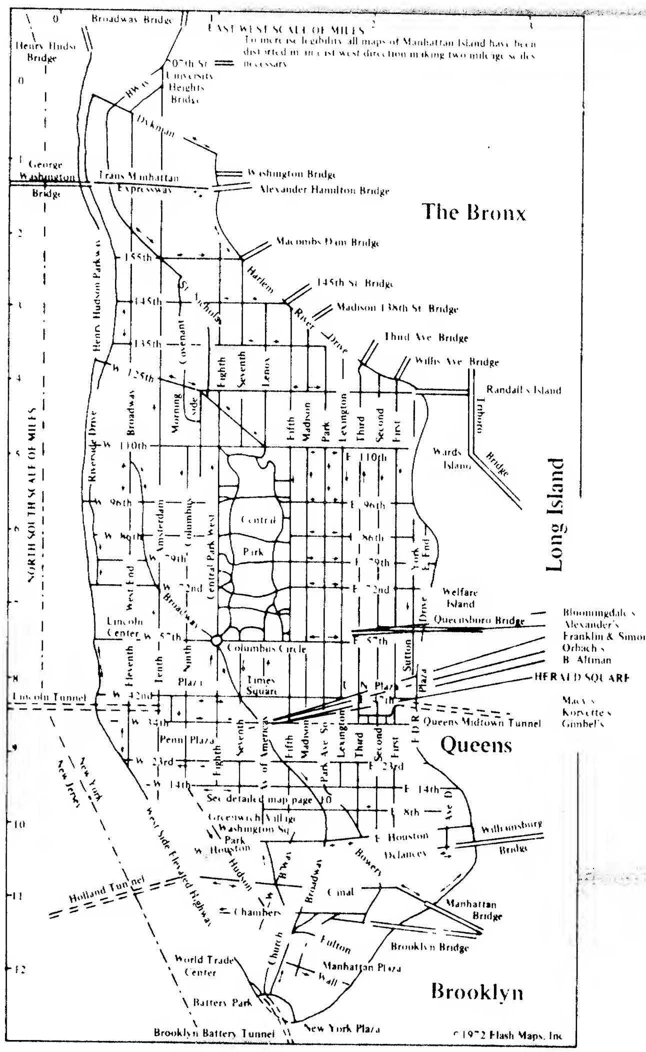
Bloomingdale's early development

5 In 1872, Lyman Bloomingdale opened a 1500-square-foot dry goods store on Third Avenue between 56th and 57th Streets. He was attracted by the two large plate glass display windows on either side of the doorway. His volume rapidly outgrew this and a second store and precipitated a move in 1886 to Bloomingdale's current location at 59th Street. In the decades that followed, Bloomingdale's continued to purchase real estate and expand at that location until by 1927 it occupied the entire city block between Third and Lexington Avenues.

6 The store's revenue growth compounded at almost 10 per cent annually over the first 50 years. Mr. Bloomingdale's creativity and innovation fostered this growth. In addition to the effective use of display windows, Bloomingdale's was among the first to experiment with full-page advertising in the daily newspapers, to install electric arc lights and telephones, and to popularize the use of escalators and elevators.

7 The developing New York City transportation system supported Bloomingdale's growth into the 20-century. In particular, the Third Avenue elevated train, the Lexington Avenue subway, and the 59th Street bridge to Queens provided easy access to the store from the north, south, and east. Transportation was important because Bloomingdale's was three miles north of the major retailing district in New York City at the time, which was located near 14th Street (see Exhibit 2). After the turn of the century, it remained over one mile north of Macy's and Gimbel's at 34th Street and Sixth Avenue.

exhibit 2
Map of Manhattan



8 Over time, the transportation improvements noted above altered the demographics of Bloomingdale's neighborhood and immediate clientele. Thus, many upper middle class families followed the Lexington subway to the area southeast of Bloomingdale's. Also, with the opening of the 59th Street bridge, the crowded tenements and busy factories southwest of the store on Park Avenue moved to Queens and modern commercial and office buildings replaced them. In addition, real estate developers began creating whole blocks of new residences along the east side of Manhattan north of the store.

9 Aided by these changes, Bloomingdale's grew and prospered through the late 1920s. In 1929, Bloomingdale's joined the newly formed Federated Department Store group to reduce its financial risk. Federated was a holding company for three major U.S. family-owned department stores: Abraham & Straus of Brooklyn, Filene's of Boston, and Lazarus of Columbus. Because of the way it was formed, Federated exerted no substantive influence over its members until 1945. Then it began an aggressive acquisition campaign to expand its geographic coverage into the rapidly growing southern and western regions of the United States. As a result of this campaign, Federated grew from four divisions (store organizations) with combined sales of \$200 million in 1945 to 20 divisions with sales of about \$5 billion in 1977.

10 As part of its expansive campaign, Federated developed strong corporate staff competences. For example, in evaluating acquisition candidates, Federated learned that site evaluation was a critical ingredient of future store success and refined its skills in that area to a level which became legendary in the industry. It also developed similar skills in economic forecasting, operations analysis, and financial control. These skills were necessary to evaluate both the performance of acquired divisions and the potential of acquisition candidates. Although Federated never attempted to centralize the store operations or merchandising decisions of its divisions, it did conduct periodic performance reviews of all its divisions. At these sessions in Federated's Cincinnati headquarters, Bloomingdale's was often cited as one of Federated's most successful divisions in terms of growth, profitability, and innovation.

Bloomingdale's top management

11 Since its founding, Bloomingdale's top-management turnover was low, especially since 1943. At that time, James Schoff became Bloomingdale's chief executive officer and recruited Jed Davidson to be chairman of Bloomingdale's. Schoff had been president of the Fair Department Store in Chicago after holding major executive positions at Bamberger's. Davidson had been president of Hengerer's department store in Buffalo and president of the James McCreary store in New York. Both had worked in the Macy's organization several years earlier.

12 At Bloomingdale's, Schoff and Davidson formed an "Office of Princi-

pals" in which they assumed joint responsibility for managing the store. So successful was their dual leadership that this arrangement became a required structure in all Federated store organizations. Usually this Office of Principals included one executive with extensive merchandising experience and one with extensive financial and operating experience in retailing. Moreover, many of the executives to hold the Office of Principals in other Federated stores received their early training in the Bloomingdale's organization.

13 Davidson recruited his former controller at James McCreary, Lawrence Lachman, to join the Bloomingdale's organization as treasurer in 1947. Later Lachman became executive vice president for personnel and operations and succeeded Schoff as president when Davidson retired in 1962. Lachman became chairman of Bloomingdale's in 1969, a post he held until 1978, and a member of Federated's board of directors in 1974. Lachman's successor as president was Marvin Traub, who joined Bloomingdale's in 1950 as assistant to the president with responsibility for the basement operation. After seven promotions in as many years, he became an executive vice president and general merchandise manager for home furnishings. His successor in that position was James Schoff, Jr., son of the former chairman.

14 Schoff, Davidson, Lachman, Traub, and Schoff, Jr. were responsible for the major developments in the store during the postwar era. Lachman described some of their early managerial decisions that significantly affected Bloomingdale's:

> We decided to change the concept of Bloomingdale's. Based on our experience, we concluded that a mass merchandise store in New York City would have a severe profit problem because of the high cost of doing business. Wages, advertising, delivery, taxes, and most other expenses had higher cost rates in New York than in other parts of the country. To make a reasonable profit, we felt we should have a high average sales check with a correspondingly high gross margin because many operating costs related primarily to the number of transactions in the store.
>
> Not every store could do that. We recognized that we had a unique location. We were on the fringe of some of the wealthiest residential areas in the world. Although we were also under the shadow of the Third Avenue elevated and adjacent to a large tenement area, all the economic research we could find indicated that there would be substantial change in our neighborhood. In particular, we felt the tenements would disappear and a number of new office and expensive apartment buildings would be built on the east side.
>
> We set out to build a new image which would attract a higher class of clientele. Immediately after the war, Bloomingdale's was a relatively successful mass merchandise store, but it was not unique, it had no distinctive character. Developing that character was not easy. Our merchandise people believed that unit volume was the key to growth and profitability. Convincing them to upgrade quality and sacrifice some low-margin product lines required great managerial courage and support from Federated.

Bloomingdale's image development

15 In the late 1940s, Bloomingdale's altered the image of the store in various ways, particularly in the kinds of merchandise it sold. As a first move, the store abandoned its pedestrian candy business and began building a high-quality delicacies department. Since no store in New York City operated a good delicacies department, management felt it could attract attention and build store traffic by offering unique epicurean delights. Thus, Bloomingdale's sent buyers to Europe to get fine foods that other New York City stores did not carry.

16 As a second move, management began to revamp its home furnishings departments about 1950 by eliminating major appliances as well as its low-price, low-quality lines of furniture and accessories. To replace these lines, Bloomingdale's recruited young, style-conscious buyers, and engaged the Frick Museum curator to train them in art history and good design. These buyers, and the fashion coordinators who advised them on interior decoration, then approached quality European manufacturers. These craftsmen, eager to rebuild their war-ravaged businesses, agreed to provide Bloomingdale's with uniquely designed home furnishings based on classical styles.

17 Merchandising these furnishings required bold new approaches to build traffic and attract newer, younger, more affluent, style conscious customers since Bloomingdale's traditional customers did not have the interest or money to purchase unique and expensive imported furniture in large volume. To build a new clientele, professional interior designers arranged the imported furnishings into museum-quality room settings and related them with a common theme.

18 The store unleashed massive promotional campaigns announcing the collections as annual import shows and stressing the themes of the shows as well as the quality and uniqueness of the furnishings displayed. Immediately these shows attracted attention. Over several years they developed a reputation as artistic events. The crowds included designers, art critics, entertainers, and cultured people from and beyond New York City. Among Bloomingdale's patrons were designers from the fashion apparel industry and gourmets from the restaurant business, as well as people who wanted to associate with them.

19 After establishing a new home furnishings image and attracting a new clientele, Bloomingdale's began to refocus its apparel business toward the needs of these same customers. During the early 1960s, its men's store was remodeled. Management modified the approach that was so successful in home furnishings by inducing quality manufacturers to create a collection of private label clothing of understated elegance. Based on the emerging Bloomingdale's reputation, some designers became enticed to display their lines in Bloomingdale's men's store.

20 Finally in the mid-1960s, Bloomingdale's began the difficult task of upgrading its women's apparel departments. Buyers began to seek merchan-

dise from the women's fashion industry in the United States and around the world. Where possible they sought exclusive designs for private labeling. Most women's apparel and accessory designers felt that selling their labeled merchandise to a department store would detract from their own reputations and from the distinction of their designs. However, a few were willing to negotiate with Bloomingdale's because the store had a distinctive clientele and fashion reputation in its other lines of merchandise.

21 Bloomingdale's then searched for designer collections of other merchandise for display and sale throughout the store. As inducements, some prominent designers were offered the opportunity to have their own shops within the store which would display only their works. In other cases, the store attempted to commission leading designers to create unique merchandise. Initially, these designers faced a trade-off between low-volume exclusivity and high-volume profits. By the 1970s, however, Bloomingdale's had created a reputation for unique, exclusive, stylized merchandise across its departments that was sufficiently strong that most designers selling to Bloomingdale's did not face the exclusivity/profit trade-off anymore.

22 Management at all levels in Bloomingdale's recognized the importance of continuing to find or develop new and unique merchandise to display and promote in ways which encouraged customers to return frequently. In addition, Bloomingdale's continued to work to make shopping exciting and adventuresome. Managers understood the importance of building a traffic of purchasing customers through the entire ambiance of the store, and not just through the quality of merchandise they sold.

23 In the 1970s, Bloomingdale's location added to the traffic. Immediately surrounding Bloomingdale's were embassies, boutiques, modern art galleries, fine antique shops, and elegant salons. After the demise of the Third Avenue elevated, the area northwest of the store was developed into residences for affluent, career-oriented young men and women eager to demonstrate their arrival with distinction. To the southeast were growing Park Avenue office buildings with executive and clerical personnel with time to shop nearby during their luncheon hours. The by now established Bloomingdale's image attracted all of these people and developed their shopping loyalty.

Bloomingdale's branch development

24 Also early in the postwar era, Bloomingdale's management recognized and began to prepare for the rapid growth of suburbs around New York City. It instituted a branch development program in 1947 by acquiring and remodeling a department store in New Rochelle, New York. As part of the program, it also built its first branch which opened in 1949 in Fresh Meadows, Long Island, a community composed primarily of young married couples.

25 Bloomingdale's was one of the first Federated divisions to grow through suburban branch development. As its expansion continued (see Exhibit 3 for

exhibit 3
Branch stores

Stores	*Date opened*	*Gross square footage*
Main store, Manhattan, N.Y.*	1886	947,000
Branch locations		
New Rochelle, N.Y.†	1947	110,000
Fresh Meadows, N.Y.	1949	
expanded	1974	149,000
Stamford, Conn.	1954	227,000
Bergen County, N.J.	1959	
expanded	1977	275,000
Short Hills, N.J.	1967	250,000
Garden City, N.J.	1972	260,000
White Plains, N.Y.	1975	260,000
White Flint, Md.	1976	260,000
Tyson Corners, Va.	1977	250,000
Home furnishings specialty stores		
Manhasset, N.Y.	1971	84,000
Scarsdale, N.Y.	1971	26,000
Jenkintown, Pa.	1972	110,000
Chestnut Hills, Mass.	1973	85,000

* This location was expanded many times and current size was achieved about 1929.

† This location became a home furnishings store in 1976.

a list of branches in 1978), Bloomingdale's utilized the site evaluation skills of Federated to select locations which would provide a continuing growth of the appropriate types of customers. Thus, it only built new branches in areas which were expected to attract customers to Bloomingdale's image and merchandise, because management felt that its branch development program would be effective only if it could maintain a uniform image in all of its stores.

26 Between 1949 and 1971, all of Bloomingdale's new branches were located in the greater NYC area. In 1972, however, Bloomingdale's opened its first store outside the New York area. It was situated in Jenkintown, Pennsylvania, a suburb of Philadelphia. This store and a second one the following year in Chestnut Hills, Massachusetts, a suburb of Boston, sold only home furnishings. The major reason for these limited lines was that management wanted to use these stores to test the transferability of the Bloomingdale's image to other regions and to identify and resolve with as little risk as possible some of the organizational problems which might result from significantly wider geographic coverage.

27 Satisfied that regional expansion was feasible, management constructed two full-line stores in suburbs of Washington, D.C., in 1976 and 1977. Also in 1977, Bloomingdale's announced plans to open a fashion apparel store in Chestnut Hills, and industry experts anticipated it would soon announce plans to begin construction of a store in the Chicago area.

Management strategy

28 Throughout most of the 1970s, Bloomingdale's management maintained as their corporate objectives the continuance of the high growth and profitability which had characterized the company's post-World War II performance. Management also planned to continue serving sophisticated, high-class customers with unique merchandise which would be sold at above-average prices and margins. Through this merchandise and clientele, Bloomingdale's planned to maintain and enhance its image as a fashion leader and source of good taste. Growth would be further enhanced by continued regional expansion, with each new branch maintaining the existing Bloomingdale's image.

29 Thus, Bloomingdale's merchandise would continue to be sold by courteous and well-informed sales people in an exciting and stimulating environment. Bloomingdale's would also provide a wide selection of merchandise within each line offered. Furthermore, this selection would be highlighted by carefully arranged displays that focused on the most attractive features of the merchandise. Each store would also group lines of merchandise to encourage complementary purchases. Moreover, the merchandise would be supported by full-service policies covering extensive returns, wrapping, delivery, fitting, and credit.

30 In addition, complete, accurate, and current inventory records would be maintained to insure that merchandise selections were adequate, just as complex manpower scheduling systems would be used to insure that all departments were adequately and efficiently staffed for anticipated customer traffic at various times throughout the day, week, and season. Strong and tasteful promotion would also be used to inform customers of the merchandise and to further communicate the image of the store. In total, the merchandise and store atmosphere would provide a coherent and consistent shopping experience for Bloomingdale's intended customers.

31 To provide this unique merchandise, Bloomingdale's would purchase from appropriate vendors throughout the world, with particular emphasis on Europe and the United States. Its vendors would be selected based on the perceived quality and design of the products they offered, as well as on the fit of their products into the total line of products to be available at Bloomingdale's. And, where possible and appropriate, Bloomingdale's would attempt to purchase products designed to its own specifications and/or labeled with its own brand. To support this purchasing effort, Bloomingdale's would assemble merchandising personnel with exceptional stylistic taste and fashion consciousness. In this regard, Bloomingdale's generally preferred to promote through its own merchandising organization than to hire experienced merchandisers from other organizations.

32 Financing for working capital and fixed investments would be provided by Federated Department Stores. However, control of cash, credit extension, purchase orders, accounts collection, and vendor payments would be handled within the Bloomingdale's organization. Integrity in dealing with

suppliers would be maintained in both contractual agreements and in appropriate payment schedules. In addition, Bloomingdale's would provide for its own physical security through the maintenance of its own security service which could interact with employees and customers in appropriate and discreet ways. The controllership function, while providing current records and maintaining finances, would not attempt to influence either the purchase of merchandise or the allocation of Bloomingdale's operating budget. It would, however, maintain fiscal accountability to the Federated headquarters.

Bloomingdale's organization structure

33 Throughout most of the postwar era, Bloomingdale's maintained a functional organization structure. As noted earlier, the primary relationship with Federated was through the Office of Principals, shared by Lachman and Traub. Within Bloomingdale's, Traub focused on the merchandising aspects of the business, while Lachman covered the remaining areas. During most of this period, six executives reported to the Office of Principals as indicated in Exhibit 4.

Merchandising

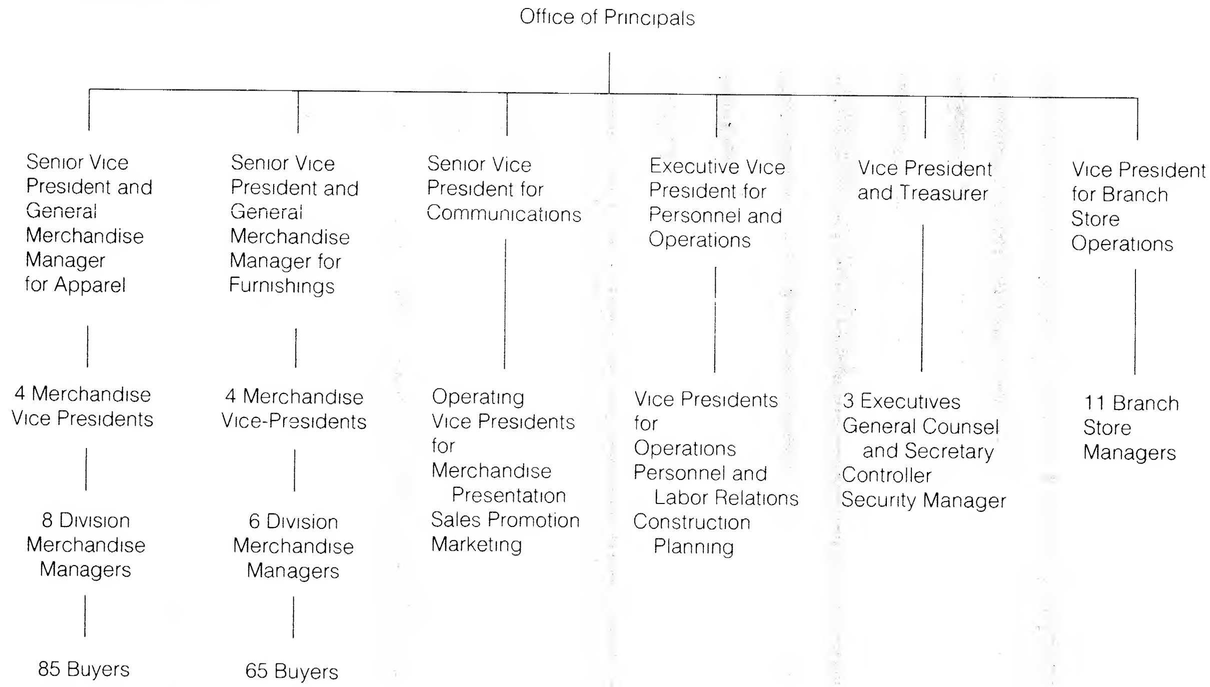
34 Many observers both inside and outside the store felt that superior merchandising was the most important ingredient in Bloomingdale's success. They noted that many department store presidents and other top executives in retailing received their initial industry training at Bloomingdale's. In addition, many college placement officers felt that entry-level positions on the store's training squad offered unusually rich experience and rapid promotions in the retailing field.

35 Merchandising at Bloomingdale's, and at most department stores, was decentralized. Each successively lower level in the hierarchy managed a narrower set of product lines, while each successively higher level coordinated a set of lines with some common characteristics or problems. Typical buyer product lines might include men's ties, women's sweaters, kitchen gadgets, or bed sheets. The revenues of such departments ranged from $1 million to $10 million annually.

36 Each buyer was also responsible for the sales and profit volume of his or her department. By integrating the buying and selling responsibility for a department in one job, Bloomingdale's focused the buyers' attention on the relationship between the merchandise and the customer. Most buyers were on the selling floor in the main store over 20 percent of the time. They felt that frequent exposure to customers and customer reaction to the merchandise strongly influenced their buying decisions.

37 Buyers also felt it was important to their departmental performances to work with vendors and designers to develop fashionable and exclusive merchandise. In this work, they received assistance from fashion coordinators,

exhibit 4
Organization chart



Note: This chart is based on company records. It has been simplified in certain inconsequential ways to provide a clearer representation of the reporting relationships. As in all major companies, the chart and personnel are in constant flux. This chart indicates more stable relations over time.

who served as staff assistants to the merchandising organization and were specialists in fashion trends, consumer taste trends, design fundamentals, and ensemble coordination. The fashion coordinators were supervised by the director of fashion, Katherine Murphy, who set the fashion direction of the store. Murphy was known and respected in fashion circles throughout the world and was often remembered affectionately by buyers who had worked with her.

38 Divisional merchandise managers worked closely with the buyers in the initial selection of vendors and in the continual development of new products for the line. They also maintained a continuity of relationships with many of the principal vendor organizations. Management felt that good vendor relations enabled them to obtain special privileges that gave Bloomingdale's unique merchandise and strong support service.

39 Merchandise vice presidents and general merchandise managers provided further elements of coordination across divisions. They generally concentrated on broader issues of image and performance and on longer range plans and trends. They also coordinated the flow of goods and people across departments and divisions, as well as the redefinition of departmental and divisional charters. For example, new product introductions or high fashion items which had appeared in one department of the store in one year were included in the assortment of another department the following year. This practice was quite important because it allowed Bloomingdale's to utilize new designs for more than one season.

Other functions

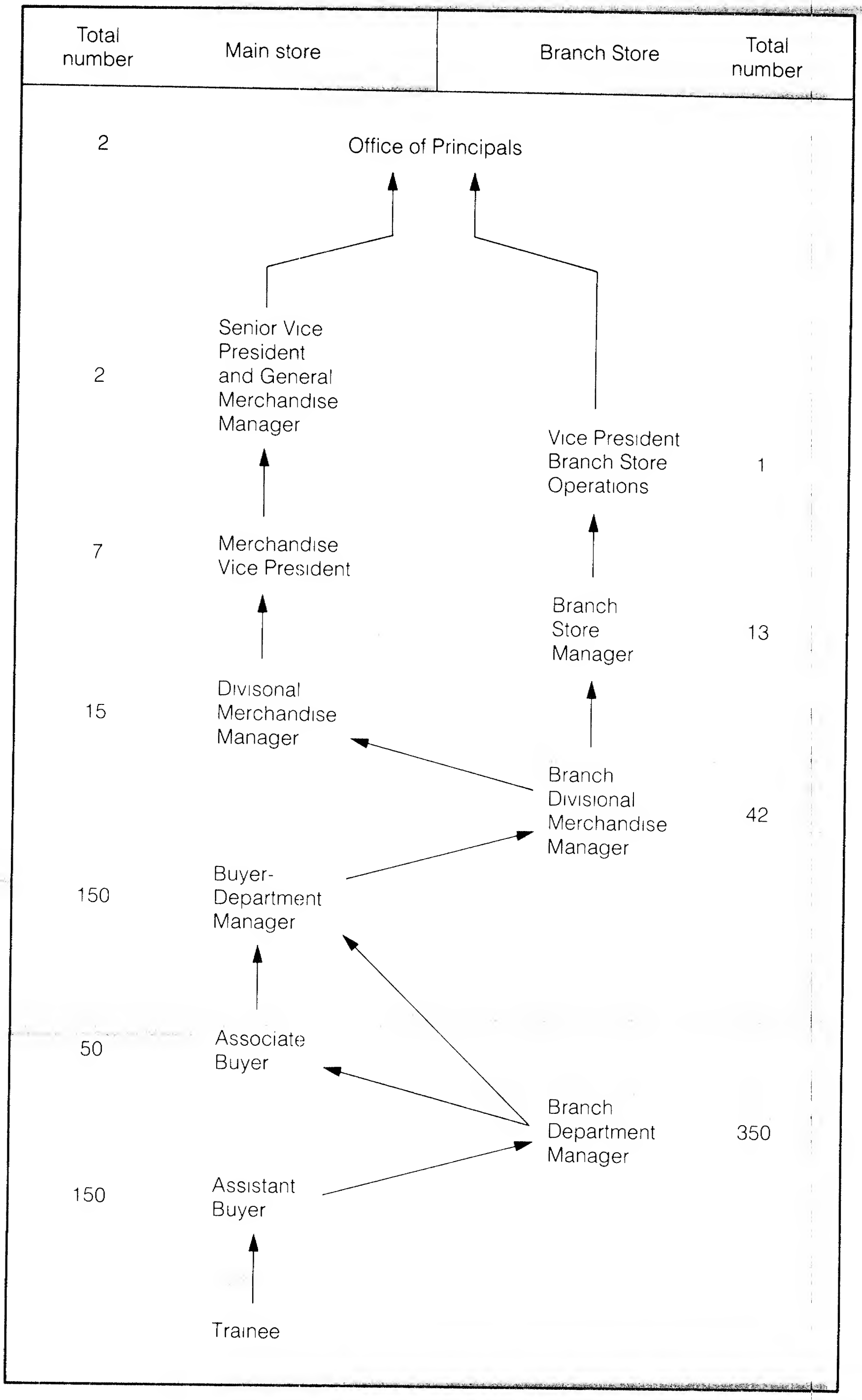
40 While important in their own right, much of the work of the other parts of Bloomingdale's organization involved support for or control of its merchandising organization. For example, the communications department provided merchandise presentation advice and promotional opportunities to supplement the ideas and suggestions of the buyers. Similarly, the operations department supplied and supervised the sales personnel, even though the buyers had responsibility for the quality of their training and service. And, besides its other duties, the personnel department recruited and screened applicants for Bloomingdale's buyer training program, although the buyers interviewed most of the finalists to select the next group of trainees.

Buyer training and development

41 Once selected, these future buyers were put in a training program for about six months. This program consisted of some classroom work under personnel department supervision and some special project work supervised by experienced buyers. Those trainees who successfully completed the program became assistant buyers. From there, they entered Bloomingdale's normal promotion path which involved alternating assignments in the main store and the branches (see Exhibit 5). Thus, after two to three years, suc-

exhibit 5

Typical promotion ladder in merchandising



cessful assistant buyers become branch department managers, merchandising the lines of several buyers. And after another one to two years, these individuals returned to the main store as buyers (or associate buyers if a position had not yet opened).

42 The rate of promotion represented a delicate balance. On the one hand, rapid advancement required major organizational investments without protracted use of the skills an individual developed in a particular area. Thus, some buyers felt that promotions occurred before their assistants had repaid the investment they had made in them. On the other hand, Bloomingdale's attracted unusually talented and ambitious individuals since one of the attractions of working at Bloomingdale's was the opportunity for rapid advancement under the guidance of successful fashion buyers. Consequently, these individuals usually were not content to remain in one position for extended time periods.

43 Also, young Bloomingdale's executives had significant external job opportunities if they were unsatisfied with the pace of their advancement. For example, competitors, large and small, sought merchandisers trained at Bloomingdale's. In addition, vendors sought good merchandisers who understood the complexities of the merchandise buying decision from the department store viewpoint. Moreover, vendor organizations claimed to offer better salaries, less unpaid overtime, better working conditions, and more responsibility than most retailers. Bloomingdale's, by contrast, paid no bonuses, commissions, or overtime to its managers, even though it expected long hours on the job. Consequently, Bloomingdale's had experienced a relatively high turnover among its branch department managers and assistant buyers.

44 In spite of these problems, Bloomingdale's preferred to train and promote from within its own organization rather than to hire experienced buyers from other organizations. One of its principal reasons for this policy was the opportunity it gave Bloomingdale's to appraise the work of potential buyers before they were assigned to the job. In addition, there was some question as to whether buyers from any other organizations would be capable of facilitating the creation of the designs at the forefront of fashion which made Bloomingdale's so distinctive. At the same time, since buyers were responsible for the sales and profits for their departments in all the branches as well as in the main store, the increase in branching was substantially increasing the time pressures on them, which had resulted in an increased turnover among buyers as well. Management was somewhat concerned about this development because, if it grew, it could threaten one of the major resources on which Bloomingdale's had built its strategy.

The competitive retail situation

45 As management looked to the future, some data helped to place its strategy and past success into perspective. Throughout the United States, retail sales

during the 1947–1977 period grew at a compound rate of 5.7 percent (see Exhibit 6). Population increase accounted for some of this growth, but overall retail sales per capita also grew at 4.2 percent during the same period. Thus, even after being adjusted for inflation via a consumer price index deflator, total retail sales grew at 2.8 percent annually, and retail sales per capital grew at 1.3 percent.

46 However, growth among various types of retail stores in the United States was uneven (see Exhibit 7). Department stores, for example, grew during the 1948–1977 period at 7.9 percent annually, increasing their share of retail sales from 7 percent to 10 percent, although his growth included two types of stores—national merchandise chains and discount stores—which

exhibit 6
Annual U.S. retail sales data

Year	*Retail sales in billions of current dollars*	*Retail sales in billions of constant dollars*	*Retail sales per capita in current dollars*	*Retail sales per capita in constant dollars*
1947	$122.4	$183.0	$ 858	$1283
1948	133.6	185.3	920	1276
1949	133.8	187.4	907	1270
1950	147.2	204.2	980	1359
1951	156.5	201.2	1033	1328
1952	162.4	204.3	1059	1332
1953	169.1	211.1	1069	1335
1954	169.1	210.1	1063	1321
1955	183.9	229.3	1133	1413
1956	189.7	233.0	1147	1409
1957	200.0	237.2	1188	1409
1958	200.3	231.3	1168	1349
1959	215.4	246.7	1229	1408
1960	219.5	247.5	1232	1389
1961	218.9	244.3	1208	1348
1962	235.6	260.0	1283	1416
1963	246.7	269.0	1323	1443
1964	261.9	281.9	1375	1480
1965	284.1	300.6	1483	1569
1966	304.0	312.8	1572	1617
1967	313.8	313.8	1608	1608
1968	341.9	328.1	1722	1653
1969	357.9	326.0	1798	1638
1970	375.5	322.9	1862	1601
1971	408.8	337.0	2002	1650
1972	448.4	357.9	2172	1733
1973	503.3	387.8	2419	1864
1974	537.8	374.0	2565	1784
1975	584.4	375.9	2764	1778
1976	642.5	392.5	3016	1842
1977	708.3	409.3	3299	1906

Source: *Historical Statistics of the United States* and *Statistical Abstract of the United States* (Bureau of Census, U.S. Department of Commerce).

exhibit 7

U.S. retail sales composition for census years

Percentage of total retail sales	*1948*	*1954*	*1958*	*1963*	*1967*	*1972*	*1977*
Traditional department stores	n.a.	n.a.	n.a.	4.54%	5.00%	4.93%	4.56%
Discount merchandise stores*				3.77	5.29	6.47	5.53
Total department stores	7.04%	6.27%	6.69%	8.31%	10.29%	11.40%	10.09%
Variety stores	1.87	1.83	1.80	1.82	1.72	1.63	1.13
Other general merchandise stores	2.92	2.48	2.45	2.03	1.85	1.85	1.37
Total general merchandise stores	11.83%	10.59%	10.93%	12.16%	13.86%	14.88%	12.59%
Food stores	21.86	23.48	24.46	23.15	22.37	22.46	22.07
Eat and drink establishments	7.93	7.75	7.59	7.46	7.58	8.23	9.01
Gasoline service stations	4.87	6.33	7.09	7.22	7.23	7.52	7.98
Apparel and accessory stores	7.26	6.56	6.24	5.67	5.29	5.51	4.73
Drug and proprietary stores	2.99	3.13	3.39	3.45	3.47	3.48	3.16
Other nondurable goods stores	11.15	7.81	8.64	8.47	8.26	4.55	6.75
Total nondurable goods stores	67.89%	65.64%	68.35%	67.57%	68.07%	66.61%	66.29%
Auto dealers	15.04%	17.68%	15.88%	18.40%	17.72%	20.92%	20.29%
Building materials stores	8.31	7.75	7.14	5.92	5.48	5.69	5.36
Home furnishings stores	4.94	5.09	5.04	4.42	4.62	5.02	4.87
Other durable goods stores	3.82	3.84	3.59	3.69	4.11	1.76	3.19
Total durable goods stores	32.11%	34.36%	31.65%	32.43%	31.93%	33.39%	33.71%

n.a. = Not available.

*Discount merchandise stores were estimated at less than 1 percent of retail sales in 1960 and negligible before that time.

Source: Discount store merchandise data from *Discount Merchandiser* (various issues). Other data for 1948–1972 from the *Census of Business* and the *Census of Retail Trade* and for 1977 from the *Monthly Retail Trade* (Bureau of Census, U.S. Department of Commerce).

competed with the traditional department store in different ways. The national merchandise chains (e.g., J.C. Penney's and Sears, Roebuck) purchased centrally, emphasized private label merchandise, and sold nationwide through both stores and catalogs. The discount stores, by contrast, sold limited lines of nationally advertised, trademarked, and branded goods below manufacturer's suggested retail price in inexpensive surroundings. After adjusting for the growth of these two types of stores, it appeared that department store retail sales grew at about 4.2 percent annually between 1948 and 1977, although these estimates were open to some question.

47 However, within the New York City standard metropolitan statistical area (SMSA), where Bloomingdale's generated most of its sales, department stores were even healthier. Thus, during the 1963–1977 period, they increased their share of area retail sales from 10.6 percent to 12 percent (see Exhibit 8). Not only were these shares higher than the national averages, but they also probably understated department store health because of two factors. First, it appeared that the national merchandise chains had lower mar-

exhibit 8
Retail sales data for selected areas of the U.S. for selected census years

	1963	*1967*	*1972*	*1977*
New England States:				
Total retail sales	15,088	18,952	27,909	39,198
General merchandise stores	1,764	2,602	3,776	6,905
Department stores	1,207	1,919	2,967	n.a.
Middle Atlantic States*				
Total retail sales	46,948	57,951	81,187	112,351
General merchandise stores	5,976	8,607	11,985	21,892
Department stores	4,325	6,603	9,763	n.a.
New York State				
Total retail sales	23,977	29,091	39,173	50,560
General merchandise stores	3,079	4,354	5,816	13,669
Department stores	2,293	3,385	4,790	n.a.
New Jersey State				
Total retail sales	9,060	11,362	16,831	24,076
General merchandise stores	1,100	1,680	2,485	7,377
Department stores	797	1,341	2,078	n.a.
New York City SCSA†				
Total retail sales	21,630	26,007	35,365	42,889
General merchandise stores	2,864	4,038	5,283	13,082
Department stores	2,039	3,244	4,447	5,088
New York City SMSA‡				
Total retail sales	15,646	18,634	20,401	26,198
General merchandise stores	2,016	2,921	2,961	6,992
Department stores	1,661	2,339	2,467	3,136

n.a. = Not available.
*Includes New York, New Jersey, and Pennsylvania.
†Standard combined statistical area includes the SMSA of New York City, Jersey City, and Newark.
‡Standard metropolitan statistical area is a census term which includes a geographic region surrounding a large city; the New York City SMSA includes the counties of New York, Kings, Queens, Bronx, and Richmond.
Source: 1963–1972 data from *Census of Retail Trade* and 1977 compiled from *Monthly Retail Trade Reports* (Bureau of Census, U.S. Department of Commerce).

ket shares from both store and catalog sales in New York City than in other parts of the country. Second, the New York City area was saturated with discount stores by 1965, so that the overall growth of these stores was probably less between 1965 and 1977 in New York City than in other parts of the country.

48 On the other hand, the New York City SMSA share of national retail sales declined from 6.3 percent to 3.7 percent during the 1963–1977 period. This decline coincided with a population decrease of 4.5 percent during the 1960–1975 period (see Exhibit 9). Part of this population decline resulted from a general migration to the southern Sunbelt states. At the same time, New York City, as most other major metropolitan areas, had suffered a migration from the inner cities to the suburbs. Because of its size and concentration, though, New York City experienced not only movement from the inner city to other parts of the SMSA, but also to areas just beyond the SMSA. And, while the Bureau of Census established the standard consolidated statistical area (SMCSA) of New York City to help capture this movement, the "consolidation" did not include the area of southwestern Connecticut where many New York City workers lived.

49 More important for Bloomingdale's, people not only moved to the suburbs, but also appeared to prefer to shop near their homes. Among the reasons cited for such preferences were the inconvenience, dirt, congestion, impersonality, heavy traffic, inadequate parking, and the poor personal security associated with shopping in downtown areas. Because of this, many stores created suburban branches in large suburban shopping malls to provide an alternative to these conditions and to maintain customer loyalty. Also, occupancy and employment costs were often lower in these malls.

50 These statistical data ignore some other important trends in the retailing industry during the past three decades, however. For example, as the discount stores attempted to further increase their share of retail sales, many also increased the breadth of their lines, improved their shopping surroundings, and increased the size of their sales staffs. As a result, their cost structures and ability to provide discounts deteriorated. Meanwhile, during the same period, department stores sought more efficient ways to process transactions and to provide service so that they generally have become more price and cost conscious than they were 20 years ago.

51 In addition, most department stores, which traditionally were single location organizations, increased their geographic coverage in two ways. First, most store organizations opened branches in suburban areas around their "flagship" downtown stores, following the population migration to those suburban areas from the inner city. Second, many local department store organizations were acquired by ownership groups (e.g., Allied Stores, Associated Dry Goods, Carter Hawley Hale, Dayton-Hudson, Federated, and May Department Stores) in order to build national chains. Such stores also sought some economics of scale in finance, administration, and operation through group ownership.

exhibit 9
Selected U.S. population data

People (000)	*1960*	*1965*	*1970*	*1971*	*1972*	*1973*	*1974*	*1975*
Total United States	179,979	193,526	203,806	206,212	208,230	209,859	211,389	213,032
New England States	10,532	11,329	11,883	12,024	12,105	12,144	12,147	12,187
Middle Atlantic States*	34,270	36,122	37,274	37,568	37,621	37,383	37,250	37,269
New York State	16,838	17,734	18,268	18,384	18,367	18,209	18,094	18,076
New Jersey State	6,103	6,767	7,193	7,296	7,349	7,331	7,329	7,333
New York City SCSA*	15,405		17,035		n.a.	n.a.	17,181	16,602
New York City SMSA*	9,540	n.a.	9,974	n.a.	9,944	9,739	9,634	9,561
New York City	7,782		7,895		n.a.	7,647	n.a.	7,482
Percent of total U.S.								
New England States	5.85%	5.85%	5.83%	5.83%	5.81%	5.79%	5.75%	5.72%
Middle Atlantic States*	19.04	18.67	18.29	18.22	18.07	17.81	17.62	17.49
New York State	9.36	9.16	8.96	8.92	8.82	8.68	8.56	8.49
New Jersey State	3.39	3.50	3.53	3.54	3.53	3.49	3.47	3.44
New York City SCSA*	8.56		8.36			n.a.	8.13	7.82
New York City SMSA*	5.30	n.a.	4.89	n.a.	n.a.	4.64	4.56	4.49
New York City	4.32		3.87			3.64	n.a.	3.51

n.a. = Not available.
*See footnotes to Exhibit 6.
Source: 1960 and 1970 data from *Population Census of the United States*. Other data from various estimates and publications of the Bureau of Census, U.S. Department of Commerce.

52 Moreover, while department stores were traditionally the most diversified stores in the United States in terms of breadth of merchandise, increasingly other types of stores have broadened their lines. Food stores, for instance, now sell a variety of merchandise which is not edible and in some cases not related to food preparation or consumption. Likewise, larger drug stores have begun selling lines of toys, giftwares, candies, and other lines unrelated to health and beauty aids; while hardware stores have moved into appliances and other home furnishings. Consequently, the department store is no longer unique in providing shopping convenience through diversity, since this is now available from many other types of stores than in the past.

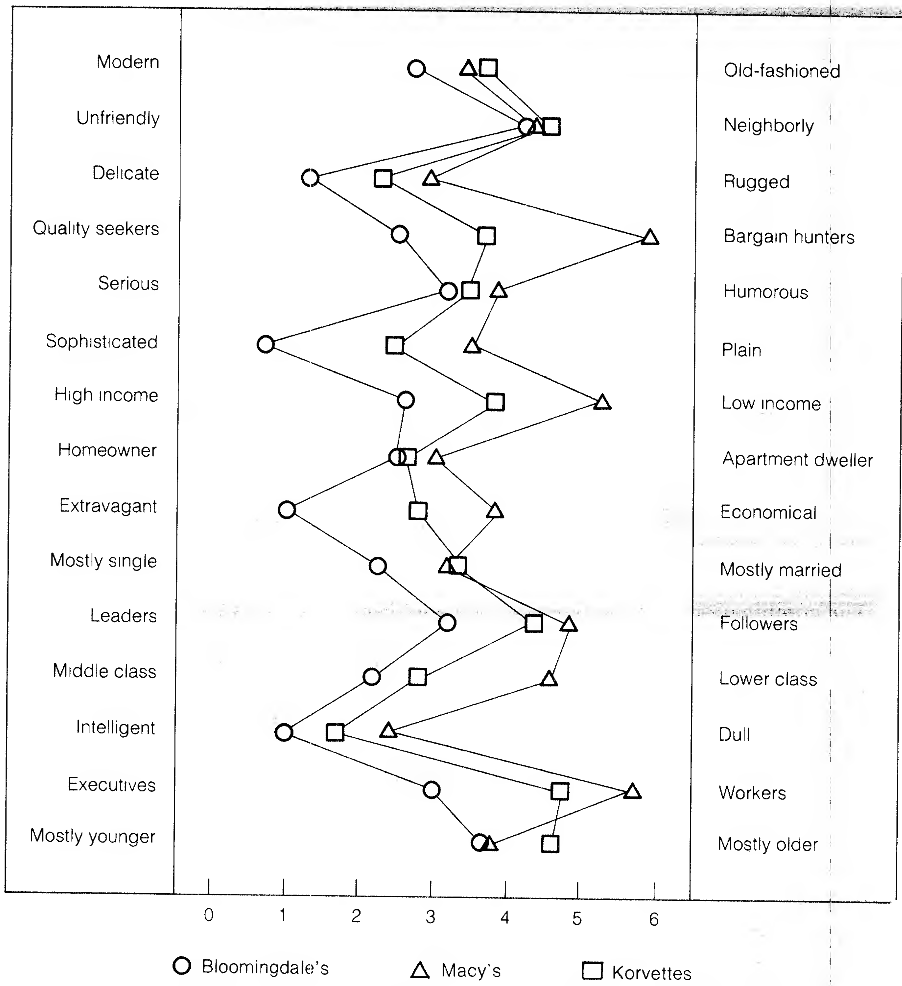
53 The average store size has also increased more in nondepartment stores in order to support this increasing diversity, with grocery stores and discount houses growing the most. However, the newer branches of department stores are considerably larger than older stores many of which had been significantly enlarged themselves. By 1975, though, the average store size seemed to be stabilizing for both department stores and the nondepartment stores that competed with them.

Bloomingdale's current competitive position

54 A recent study indicated that Bloomingdale's strategy had developed a rather enviable image within the New York City retailing community (see Exhibit 10). Based on a limited sample of shoppers, the study concluded that shoppers characterized Bloomingdale's patrons more in terms of adjectives such as quality seeking, sophisticated, high-income, extravagant, leaders, and executives than they did the patrons of Macy's or Korvettes.

55 In response, at least one store—Macy's—had recently made some efforts to substantially change its image in a direction that would be more directly confrontative with Bloomingdale's (see the Appendix). Publicly, the managements of both organizations expressed unconcern and avoidance of direct competition. External observers, however, were watching closely developments such as the decreasing growth of the New York City metropolitan area, the decreasing number of new areas where Bloomingdale's could open new stores without facing already established competition, and the problems Bloomingdale's was having developing sufficient numbers of adequately trained personnel internally, and wondering whether "Bloomie's" could continue to meet its historical growth and profitability goals? Whether any strategy modifications would be required to do this? And, if so, what these modifications might be?

exhibit 10
Selected New York City department store images



Source: Irving Burstiner, "A Three-Way Mirror: Comparative Images of the Clienteles of Macy's, Bloomingdale's, and Korvettes, "*Journal of Retailing*, Spring 1974, pp. 24–36. The study asked an unbiased sample of shoppers to characterize these three department stores on the above dimensions, between zero and six. The graph indicates the averages of the responses.

Appendix

Macy's catches up to lead the parade*

R. H. Macy, long considered one of the giant sleeping bears of American retailing, has come alive lately with more than just a stretch and a whimper.

The 76-store chain topped the results of any major retailer in the fiscal quarter ended April 30 with a mammoth gain in its net income over the comparable period in the year before. The gains were uniformly strong in five of the six Macy store divisions, with Ohio as the exception.

Also, after years of up-again, down-again results, its New York division, with 16 stores stretching from New York City to Albany, has in recent months led the area in its rate of sales gain.

The division's anchor store, Macy's Herald Square, the city's largest, returned last year to the no. 1 position as the nation's biggest-volume store, passing the J. L. Hudson Company's Detroit store, which itself had edged out the Manhattan store in 1975.

While the national and regional achievements represents a turnaround from earlier erratic results, what gives Macy's distinction is that the improved results were obtained by careful planning, strong execution, and the application of well-spent capital outlays.

The combination of those three elements allowed R. H. Macy in the April quarter to overcome the inflation squeeze on consumers that afflicted the earnings of some other retailers. Federated Department Stores, the largest department store chain, suffered a 4.5 percent drop in its quarterly earnings, for example, and the May Department Stores Company, one of the "big three" full-line chains, had an 11.3 percent decline in net in the period.

Perhaps the most intriguing part of Macy's big earnings jump was the fact that it obtained a big return on a more moderate sales gain of 14.3 percent. Thus Macy's appears to be achieving the difficult goal of every retailer, improved productivity and a better bottomline, although much of its improvement comes from comparison with a low base the year before.

In fact, the boom in Macy's New York division not only represents a strong turnaround but also reflects weak competition. A higher-than-national unemployment rate, local economic problems and a decline in night shopping have hurt area retailing, but Macy's 16 stores in the area have surmounted the problems.

* * * * *

During the last two decades of its 119-year history, R. H. Macy became perhaps the most notable example of the middle-of-the-road department store. It had broad, basic merchandise assortments, but through the 1950s and early 1960s it was also a pioneer in presenting moderately priced copies of Paris high fashion.

In recent years, as fashion leadership slipped from the salons of the couturiers to

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*This material is excerpted from Isadore Barmash, "Macy's Catches Up to Lead the Parade," *New York Times,* July 24, 1977, sec. 3, p. 1 ff.

European ready-to-wear and to small boutiques all over the world, Macy's seemed to lose its innovative flair, especially to its uptown competitor, Bloomingdale's.

This conservative trend continued virtually without change, while several Macy managements basked first in their policy of "6 percent less for cash"—later disowned in the hot flush of credit cards—and then in the chain's reputation for stocking merchandise up to the hilt in all six store divisions. This allowed Macy's to absorb any unexpected sales surge, while maintaining a policy of returning much unsold goods to suppliers that agreed to take them back because of Macy's buying clout.

Macy's also got some promotional, if not emotional, mileage out of its claim of having "the world's largest store" on Herald Square, although it really wasn't. Marshall Field on Chicago's State Street was—and is.

* * * * *

But in the 1960s the giant New York operation, with the Herald Square store as its centerpiece, lost ground. Its sales gains eroded and its profits slimmed. Yet just across the Hudson River, the Bamberger's New Jersey group continued to thrive and throw off the best profits in the company through concentration on most-wanted goods and on merchandising changes.

* * * * *

With the New York group accounting for about one third of R. H. Macy's annual sales but losing its market share, the seriousness of the situation was not lost on the corporate management. But it acted slowly, even glacially.

In the 1960s the top brass, then headed by Hack I. Straus, chairman, and Donald B. Smiley, president, watched in hope but without taking any action, as the New York stores treaded water, despite major efforts by David Yunich, the division's president and later its chairman, to grapple with the problems.

At least some of these were directly related to the city's and area's economic headaches. The jobless rate rose. Residents were fleeing. And fear of crime hurt night shopping. But at a time when Bloomingdale's was blooming despite the economic difficulties, it was obvious that Macy's New York, the city's biggest retailer, needed a new approach. Since improvement didn't appear to be developing, the efforts of the Yunich team came under fire.

* * * * *

In 1972 Yunich left to become chairman of the Metropolitan Transit Authority and in September of that year, when Molloy retired, Seegal succeeded to the role of corporate president.

This left Seegal free, with Smiley as the new chairman, to further energize any or all of the store divisions. For years after becoming president of Bamberger's in 1962, the austere no-nonsense Seegal had carefully developed a team of younger men to function in his style and believe in his philosophy.

The Seegal tenets were: test and retest departmental performance. Boost sales yield by realigning departments, changing merchandise concepts or shifting personnel. Keep adding new stores in existing markets but also expand the trading radius.

Within 18 months, Seegal deployed five of the brightest members of his team to head up six of the company's divisions. But the most fortuitous move may have been his shift of career Macyite Edward S. Finkelstein from the presidency of the San Francisco stores to the New York division in January 1974. A pudgy, genial mer-

chandiser, Finkelstein, then 49 years old, soon demonstrated that he was not only an apt Seegal pupil but a conceptual thinker on his own hook.

In a late 1974 interview, he conceded, "Herb Seegal has been a major influence on my merchandising life, but I spent 14 years at Macy's New York before I went to Bam's and then to California.

So I understood the New York operation too, before I went anywhere else. What we want to do now is to install the same methods and systems in New York that worked in New Jersey and California. These are both also highly competitive markets and there is no reason why the same methods can't work here."

That was more than two years ago. Obviously, much has been accomplished. But at least in one respect, the effort has had an ironic element. Instead of the New York division showing the way, the reverse has been the case.

The basement budget departments in Herald Square, Roosevelt Field and in other area stores have been discontinued in favor of an airy series of housewares and gourmet food enclaves known collectively as "The Cellar," as in the San Francisco store. More strategic and profitable departments, such as linens and domestics, have been highlighted on upper floors and several million dollars of less profitable departments, such as pharmaceuticals, have been scrapped.

In effect, Finkelstein has brought California to New York, while a steady shift away from a basic promotional approach to more fashionable goods to lure middle- and upper-income shoppers has been under way in all of Macy's six divisions.

"In our merchandising efforts," Smiley said in a recent interview, "we have a cohesiveness among our merchants that we haven't had before and the result is that approaches and merchandising philosophy have stabilized."

Implicit in all of it, however, has been a push to increase apparel and other soft lines, at the expense of hard lines, for profit's sake. "In the last five years," notes Smiley, "our soft lines percentage of total sales has moved up from 55 percent to 63 percent. This is by and large the profitable part of the business—you get better margins and higher inventory turnover from it."

* * * * *

Last Christmas, Macy's New York tried to put it all together in a drive not only to reap its seasonal share from its massive 6 million square feet of store space in the metropolitan area but to be "the big gift store, too."

* * * * *

Implicit in all this . . . was that New York's biggest retailer hadn't captured its Christmas share of the market in the past.

* * * * *

Most of New York's top retailers, some of them grappling with turnaround moves of their own, don't stint in their praise of what Macy's had wrought.

"No doubt about it, Macy's had done a remarkable job, but they certainly haven't done what we have, nor have they stolen away our customers," said a Bloomingdale's executive, who asked not to be identified. "They've traded up, but they haven't been able to corral the upper East Siders down there, and they haven't gotten the affluent shoppers to come down en masse, either. What they've actually done is to more successfully entrench themselves in the middle-income market."

Walter Loeb, a senior analyst for Morgan, Stanley & Company, said : "It takes a

long time for customers to be reeducated and sometimes that needs a charismatic type of event. This is especially true with the more sophisticated shoppers. Macy's did it with The Cellar, its first floor boutiques, and its new sixth floor linens and domestics section. All that created new excitement, a new presentation and, in fact, the development of a new franchise with the public."

* * * * *

A trendy cellar on 34th Street*

At a birthday party for restauranteur George Lang the other evening at the Cafe de la Paix in the St. Moritz, Lyn Revson was explaining that "Macy's is wonderful, but so far away."

The former wife of the late Charles Revson, the cosmetics king, added, however, that the "new" Macy's was "a good place to stop on the way to Madison Square Garden."

All around Manhattan, brown paper shopping bags with the big C emblazoned on them are carrying home goodies from Macy's Cellar, the city's newest major gourmet center and shopping bazaar for the affluent and upwardly.

The bags are even seen in the heart of Dry Dock country, where Bloomingdale's is headquartered. Macy's at Herald Square may be out of sight for fashionable East Siders—but no longer out of mind.

For more than a year, the largest department store in New York has been undergoing a systematic, floor-by-floor renovation that aficionados have been calling "the miracle on 34th Street" in tribute to its show business style and its bold departure from a stodgy past.

What used to be the budget basement is now the chic Cellar—a travertine-floored promenade 20 feet wide with London-style food stalls positioned along one side and casual open displays of food equipment, gadgetry, and cookware arrayed along the other—not unlike the original cellar in Macy's Union Square store in San Francisco.

A branch of P. J. Clarke's, the Third Avenue saloon-style eatery, is tucked behind the refurbished old mahogany-sided elevator in the new Cellar. At lunchtime, such Seventh Avenue notables as Bill Blass have begun to make regular appearances.

The Cellar on a Sunday afternoon can be reminiscent of the Central Park Mall in its social diversity and foreign accents. "This must be like Bloomingdale's," a middle-aged woman said firmly to her husband while strolling along the promenade one recent weekend.

According to Thomas Raney, the lanky Texan who is Macy's vice president for sales promotion, the store is "expanding the same techniques" to broaden its market, but is not in "head-to-head competition" with the trendy Bloomingdale's which is part of Federated Department Stores.

Unlike the Bloomingdale's store at 1000 Third Avenue, Macy's has an architectural heritage that is being rediscovered under layers of postwar paint and plaster. Sculpted interior columns have appeared and, in places, the linoleum has been peeled back from floors to reveal the original travertine. Five huge crystal chandeliers were discovered gathering dust in the basement and have been rehung on the ground floor.

*This article was a companion piece to the one above. The reference is Eden Ross Lipson, "A Trendy Cellar on 34th Street," *New York Times*, July 24, 1977, sec. 3, p. 2.

Change is gradually spreading through all floors. The linen department on the sixth floor, which opened last fall along with the Cellar, could pass for a stage set imitating a temple of Morpheus. It has dark carpeting, dramatic lighting, and a double circle of color-coded displays. On the outer ring are blankets, towels, and comforters in open bins. On the inner ring are patterned bed sheets and curtains. Sale merchandise is at the hub.

The new fourth-floor children's world, complete with an ice-cream pavillion, barber shop, and pet shop, will open at about the time school starts—September 15. The fifth floor, with luggage, active sportswear, cameras, and a new book department will be fully reopened by mid-August.

A special report by Tobe Associates, merchandising consultants, praised this Macy's redesign, calling it a "people classification store, one that will be easy to shop in, that will entertain and amuse."

Space itself is a crucial variable with many departments containing more than 40,000 feet of floor area.

Changes are coming to the outside both literally and promotionally. Not only is the Macy's facade being cleaned but more festivals have been added to complement the traditional Macy's Thanksgiving Day parade—a major autumn New York event for decades.

The fireworks were tripled this year for the Fourth of July display in the Hudson River, with Macy's paying the tab for three barges and 25 minutes of sky rockets and other pyrotechnics.

During the week before Easter, the outdoors is brought back indoors with a Macy's flower show on the main floor. It is glamorous enough to attract after hours charity galas attended by the social set—the same party-goers who can be found at similar functions at Bloomingdale's.

case 10

The Cold-flo™ Ammonia Converter—Imperial Oil Limited (revised)

1 In Edmonton in May 1978, John Singer was considered an offer for the exclusive distributorship of an innovative fertilizer applicator called the Cold-flo Converter. As field services coordinator of agricultural chemicals for Imperial Oil (the Exxon Canadian affiliate), he felt that the converter would be an improved method for applying the popular fertilizer, anhydrous ammonia. John wondered if prairie farmers would accept the new applicator and if Imperial Oil should be directly involved in selling the applicator.

Background information

2 Imperial Oil entered the fertilizer market in 1963 with Engro fertilizer in granular form. This was done for two reasons. First, a major competitor, Federated Co-op Ltd. of Saskatchewan, sold both petroleum and fertilizer while Imperial Oil distributed only petroleum. As a defensive move, Imperial Oil entered the fertilizer market with fertilizer purchased from Cominco. Secondly, Imperial Oil entered the fertilizer market to provide increased earning opportunities for its independent Esso agents. Prior to the introduction of fertilizer, Esso agents had depended on bulk petroleum and lubricants for their income.

3 In 1965, Imperial Oil realized that service demands for fertilizer had changed. A more efficient distribution system was needed. The company commenced a test building program for fertilizer warehouses and a manufacturing feasibility study.

4 In 1966 and 1967, Imperial Oil completed construction of the field warehouse network at a cost of $7 million.

5 In 1969, the company built a $57 million fertilizer plant in Redwater, Alberta with an annual capacity of 500,000 tons. Several bottlenecks in the plant had been worked out since 1969, and the plant's present capacity was about 700,000 tons.

6 In 1971, Imperial Oil added anhydrous ammonia (NH_3) to the Engro family of fertilizers. NH_3 was a big success. The total market for this product had grown from 20,000 tons in 1971 to about 155,000 tons in 1978. In 1978, the average ammonia customer purchased 13 tons. The total NH_3 market was expected to grow for many years at an annual rate of 10 to 11 percent.

This case was prepared by James Graham, with the assistance of Denise Palock and Michael Fuller, all of the University of Calgary. Reprinted with permission of the Case Research Association.

Imperial Oil's gross margin on NH_3 was more than twice the gross margin for granular fertilizers which was approximately 5 percent.

7 The total prairie market for fertilizer was 1.5 million tons in the 1977–78 crop year. Imperial Oil presently held about 21 percent of this market. In Alberta, Imperial Oil's severest competition came from Sherritt-Gordon, a large mining company, and Western Co-ops Ltd.[1] Sherritt-Gordon had a plant in Alberta and marketed agressively through a network of independent dealers and wholesaled through the United Grain Growers (UGG) elevator chain. Another major competitor in Alberta was Cominco. Cominco, owned by one of Canada's largest firms, CP Investments, had a network of independent dealers who sold Elephant Brand fertilizer. In Saskatchewan, the Saskatchewan Wheat Pool had a major chunk of the market. The Prairie Wheat Pools, UGG, and Federated Co-op, all depended heavily on the ''co-op doctrinaire'' segments of the Prairie population (about 40 percent). John Singer estimated that half of the cooperative segment always patronized the wheat pools. The other half, primarily larger farmers, could be lured away by Imperial Oil if Esso agents offered equally attractive prices and better service. Compared to the wheat pools, Esso agents were more likely to have application equipment and products available when needed, and were more willing to work after hours to supply service to customers. The wheat pools, as farmer owned co-operatives, repatriated profits to customers at the end of the crop year. The dividends returned on fertilizer sales had been as high as 10 percent of the purchase price.

Anhydrous ammonia and other fertilizers

8 There are three types of fertilizer: granular (crystals and pellets of fertilizer), solution (fertilizer mixed with water), and gas, (NH_3). Imperial Oil did not sell solutions although two of its competitors, Manitoba Wheat Pool and Simplot, did. John Singer knew that Imperial Oil had not found solutions profitable. Solutions were also the most expensive form of fertilizer to the farmer.

9 Consumption (in tons) of the best-selling nitrogen fertilizers ranked as shown in Exhibit 1.

exhibit 1

Name	*1974–1975 season*	*1975–1976 season*	*1976–1977 season*
Anhydrous ammonia	81,585	127,309	145,872
Ammonium nitrate	207,687	239,673	202,394
Ammonium sulphate	54,499	64,891	44,194
Urea	86,843	105,416	144,161
Urea ammonium nitrate solution	20,266	24,504	40,084
Total	450,880	561,793	576,705

[1] Western Co-ops Ltd. was owned by the Alberta, Manitoba, and Saskatchewan wheat pools and Federated Co-op. Western Co-ops and Cominco had both completed major expansions to their fertilizer production facilities in the last two years.

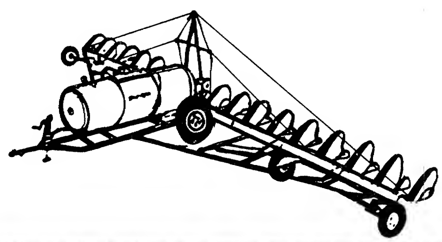
10 Granular fertilizer was used across the Prairies. Anhydrous ammonia was used primarily in Alberta, although it was expanding rapidly into Saskatchewan and Manitoba. Solutions were prevalent in Saskatchewan and Manitoba.

11 These fertilizers could be distinguished from one another by the percentages they contained of the nutrients nitrogen (N), phosphate (P_2O_5), potash (K_2O), and sulphur (S). For instance, 21-0-0-24 indicated a fertilizer that contained 21 percent N, 0 percent P_2O_5, 0 percent K_2O, and 24 percent S. While all crops were physiologically indifferent to their source of nutrients, different crops used varying amounts of nutrients. Also, soil types affected the form and amount of fertilizer required.

12 Granular fertilizers were applied by spreading them over the surface of the soil (top dressing) or by drilling them into the soil with seed. Solution fertilizer was sprayed on the soil. Anhydrous ammonia was injected into the soil as a liquid using a specially equipped tillage tool that plowed the liquid in the ground.

The Conventional NH_3 Applicator

Standard tool bar width = 45 ft. (13.7m)
Standard tank capactiy = 1000 U.S. gal (3785ℓ)



13 Anhydrous ammonia application presently required an NH_3 tank and truck (for agent-to-farm delivery) and an NH_3 applicator (see above). Conversion kits could be installed on conventional tillage equipment as well. These were less costly but less efficient than a standard NH_3 applicator. Presently, 90 percent of Prairie ammonia customers used the conventional applicators and 10 percent used the conversion kits.

14 Regardless of the application method used, it was important that the NH_3 be injected at least 6-3 inches (15-20cm) in the soil. If the NH_3 was injected too shallowly or under adverse soil or moisture conditions, the liquid NH_3 quickly vaporized with the reduction of pressure and temperature increase and the gaseous NH_3 would escape from the soil.

15 Anhydrous ammonia could be applied in the fall or spring. In the fall, cooler soil temperatures reduced the loss of NH_3 due to evaporation. However, spring application was more popular. In the spring farmers were more

certain of their cropping plans and could judge accurately the amount of nitrogen that the soil required. Also, for sandy soils spring NH_3 application reduced the risk of leaching loss. The seasonal demand for fertilizers has resulted in dealers being unable to supply fertilizer and application equipment in sufficient quantities to meet demand during peak periods.

16 Anhydrous ammonia had to be carefully handled since it could burn exposed skin by freezing. Exposure to high concentrations of NH_3 vapor or liquid could be fatal. However, NH_3 was easily detected by its pungent odor and first aid was very simple: apply lots of water.

The Cold-flo Ammonia Converter

17 The Cold-flo Converter was developed by United States Steel (USS) in conjunction with researchers at Pennsylvania State University. USS had marketed the converter as part of its "conserve America's energy resources" advertising strategy. The offer by USS for exclusive distributorship of the Cold-flo system was made to Imperial Oil by accident: representatives of the two companies had met during rock phosphate negotiations in April 1977. A tentative verbal agreement giving Imperial Oil exclusive distribution rights for three years was made in June 1977. John Singer had to present his recommendations to the field services manager, Doug Mackenzie, late in June 1978. A final decision had to be made at that time.

18 The Cold-flo Converter consisted of a small cylindrical chamber that changed NH_3 to a liquid at atmospheric pressure. The conventional application applies to NH_3 as a gas under slight pressure. The converter had two basic functions, it served as an expansion chamber for pressure release and separated liquid ammonia from ammonia vapor. Ammonia was metered into the converter from a nurse tank by means of a regulator. After conversion, the liquid ammonia flowed by gravity from the bottom of the converter through a manifold and hose system into the soil. Vaporized ammonia exited from the top of the converter to a second manifold and hose system into the soil. About 85 percent of the NH_3 was a liquid and 15 percent vapor.

19 The Cold-flo Converter had several advantages. It was a low-cost method of fertilizer application because the ammonia could be applied as the soil was tilled. This meant that one trip over the field was eliminated and time, equipment wear, labor, and fuel were saved.[2] Also, herbicides could be incorporated into the application procedure. The Cold-flo system could be used on soil too heavy for use of a conventional applicator for NH_3.

20 Since the Cold-flo Converter applied NH_3 to the soil as a liquid, sealing problems (holding the gaseous NH_3 in the soil) were minimized and shallower application was possible. Ammonia could be applied to the soil as shallow as four inches (10cm) deep near the feeder roots of most crops. Deeper placement was recommended for coarse textured soils.

[2] In the United States, the savings had been estimated at \$1–\$2 per acre.

21 The Cold-flo Converter could be mounted on most standard field cultivators, chisel plows, or disc harrows. A farmer could purchase the mount or make one himself. In the United States, the Cold-flo Converter had been most widely used on field cultivators. The procedure for setting up the system varied only slightly for chisel plows and disc harrows.

22 The successful operation of the converter with any tillage equipment depended on four factors. First, there had to be proper calibration of the NH_3 regulator to the rate of application per acre to ensure proper rate of application. Second, liquid and vapor hoses had to be properly arranged so that the NH_3 flowed in a uniform and unrestricted fashion to ensure even application. Liquid hoses had to be downward sloping. Third, liquid and vapor attachments had to be properly placed to ensure complete coverage of the ammonia. Finally, the correct number of liquid and vapor outlets had to be used. United States Steel had developed tables for determining the proper number of outlets and the best application rates per hour per acre.

Some considerations

23 The Cold-flo Converter had been tested by the Department of Land Resource Science at the University of Guelph. The results of the testing had been published by the Ontario ministry of agriculture and food in May 1978. The report found the converter to be simple and safe but also raised a number of questions.

24 The Ontario ministry warned that heavy crop residues, wet soil conditions, or fine soil texture could increase the escape of vaporized NH_3 from the soil. Also, ammonia losses could result when the converter was used with a disc harrow because disc penetration was uneven and varied between two and six inches (5 and 15cm). Further, the ministry thought that the gravity flow system might be hampered when driving over sloped land. There was also a danger that the NH_3 would damage germinating seed if improperly applied. The ministry acknowledged, however, that no published data existed that compared the Cold-flo system to other methods of nitrogen fertilizer application.

25 John Singer said any fertilizer was capable of damaging seed if improperly applied. He felt that the problem of seed damage had been satisfactorily solved by three methods used by American farmers familiar with Cold-flo. One method consisted of applying NH_3 at an angle or opposite to the direction of planting. Another method was simply to ensure that the NH_3 was applied at least four inches below the soil surface. Finally, a farmer could wait about a week after NH_3 application before planting.

26 It was possible that farmers, like the Ontario ministry, might overestimate the loss of vaporized NH_3 from the soil. This was because a white cloud could sometimes be observed rising from the soil where NH_3 had been applied. While some of this cloud could be gaseous ammonia, most of the vapor was water that condensed upon contact with the cold NH_3 liquid. Also, any loss of ammonia could be smelled around the tillage equipment.

27 Another aspect of Cold-flo merited consideration. If Imperial Oil marketed the system, the company would be able to associate itself with an innovative product. There was nothing to stop competitors from supplying NH_3 for the Cold-flo converter because the pressurized NH_3 tanks were standardized. Further, the demand for NH_3 exceeded supply in the Prairie market. In the short term, Imperial Oil was unwilling to invest in storage and transportation equipment sufficient to supply all the present markets in any one location because customers who shopped around for NH_3 would leave Esso agents once competitors had a local supply of NH_3 and were able to satisfy the customers in the area. John believed the NH_3 market to be dislocated due to these growing pains, especially in Alberta.

28 An alternative existed to the Cold-flo system. A Nebraska firm had developed a "Can Converter" system that operated on the same principle as Cold-flo except that the canister-like converters were small and mounted on each shank of the tillage equipment. USS had viewed the system as an infringement on its patent and had purchased the rights to the system, although the Can Converter system did not work nearly as efficiently as the Cold-flo system.

The Cold-flo Converter and Esso agents

29 Imperial Oil had 450 Esso agents in the Prairies, 70 of which sold anhydrous ammonia. These agents were independent businessmen who sold Imperial Oil products on a commission basis. They were serviced and supervised by 28 sales representatives in three areas.

30 Esso agents were encouraged by Imperial Oil to sell both petroleum and fertilizer products. Many agents, particularly in the small rural communities, had combined incomes. Along with Imperial Oil products they sold everything from herbicides to insurance and equipment. Sometimes an agent was related to the farmers that he sold to.

31 Imperial Oil's best agent, located in Lacombe, sold 6,000 tons of granular fertilizer a year. Two other Esso agents sold 5,000 tons yearly. The vast majority of Esso agents sold between 1,000 and 4,000 tons of fertilizer yearly. Esso agents received a commission of \$65 per ton of NH_3 sold and \$10 per ton of bulk granular fertilizer sold. About 70 percent of the granular fertilizer sold by Esso agents was in bulk, rather than bagged.

32 Fertilizer sales were becoming an increasingly significant portion of agents' total income. This was due largely to the growth of NH_3 sales. An agent just starting to sell NH_3 could be virtually guaranteed \$25,000 in gross commissions in the first year with a \$50,000 investment in equipment. Petroleum products did not have this growth factor. An agent earned between 4–6 cents per gallon on fuels and lubricants, and had to work all year to sell them. On both petroleum and fertilizer sales, agents would net about one third of their commissions.

33 In addition to selling Imperial Oil products, Esso agents rented fertilizer

application equipment.[3] This service saved farmers from investing in little-used application equipment. Esso agents, along with farm radio and newspapers, were also a source of information. When fertilizer shortages occurred in 1974 and 1978, the agents had advised farmers of the impending shortages and price increases.

34 This information service provided by agents could have a variety of effects. During fertilizer shortages, agents received a strict allocation of product. Naturally, the Esso agents wanted to ensure that their regular customers received fertilizer and so told them to order early. The agents hoped that this action would encourage their regular customers to remember them in the future, if fertilizer prices dropped and the agents faced stiff competition. However, news of shortages caused farmers to shop around in an effort to obtain fertilizer. This behavior heightened apparent demand.

35 As the price of fertilizer rose in a shortage situation, farmers often purchased more rather than less fertilizer. This was due in part to hoarding, but the major reason seemed to be the general economic outlook. In 1974 and 1978, the price of grain had risen; farmers believed that they could afford to purchase fertilizer and fertilizer purchases reduced their taxable income. The increase in yield resulting from the use of fertilizer more than offset the cost of buying and applying the product.

36 Esso agents also provided farmers with information concerning the safe handling of anhydrous ammonia. The agents could supply 20-minute audiovisual cassettes that explained NH_3 characteristics and handling procedures.

37 If Imperial Oil adopted the Cold-flo system, the agents would have to fulfill several requirements. These would be:

1. Supplying the NH_3 to existing nurse tanks and continuing to provide delivery of NH_3 to existing nurse tanks.
2. Using a Cold-flo installer from Esso Chemical to set up the initial unit at the agency and for troubleshooting thereafter. (Once the setup of the system was demonstrated, farmers would be able to install the equipment themselves.)
3. Encouraging farmers to request the installer early, since its availability would be limited prior to and during the fertilizer season.
4. Providing Cold-flo Converter kits to farmers composed of: 1 Cold-flo Converter, liquid and vapor manifolds, and hoses.
5. Providing liquid and vapor dispensers designed for Cold-flo to be attached to the shanks of tillage tools.
6. Providing converter mounting stands.

[3] Esso agents owned and financed all mobile equipment (e.g., fertilizer applicators, NH_3 nurse tank trailers, trucks). Imperial Oil owned all fixed equipment (e.g., warehouses, fertilizer tanks) and paid the depreciation and interest on mobile equipment. The pay-out period for mobile equipment was five years.

7. Providing Cold-flo splitters and extra manifolds for extrawide tillage equipment.

38 Esso agents would obtain Cold-flo equipment from Esso Chemical. They would be invoiced on their 30-day merchandise accounts. Parts for Cold-flo equipment would be ordered by telephone. Delivery of parts from inventories held in Calgary and Winnipeg would normally take two to five days.

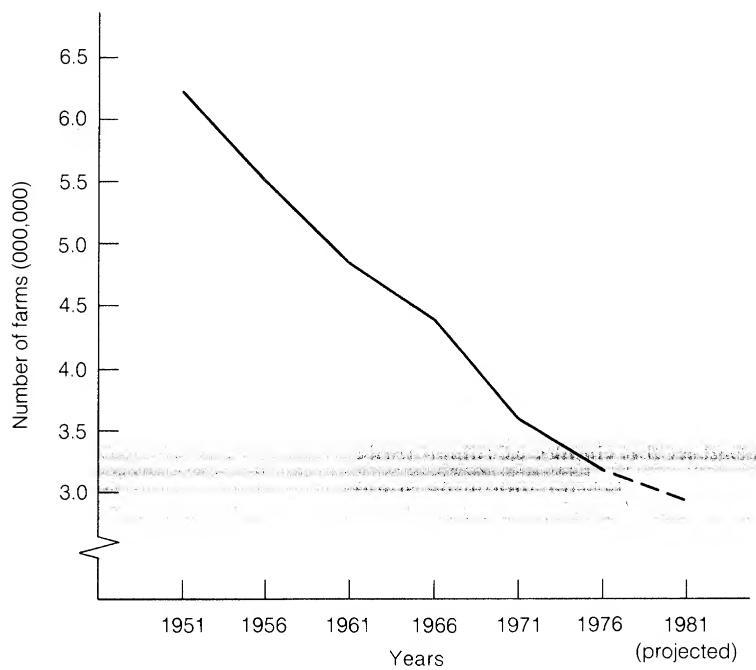
39 The selling price for the Cold-flo equipment could be kept under $1,000. If the price was more then $1,000 the agents would have to be licensed under the Provincial Farm Implements Act to sell farm equipment. Licensed dealers were controlled in that they were required to service equipment sold and meet other requirements such as keeping up repair parts for as long as one year after the sale of the equipment.

40 Customers should be aware that Imperial Oil was willing to refund the price of any Cold-flo unit found to be unsatisfactory with normal use. This guarantee would be good for 12 months after the date of purchase.

The Cold-flo Converter and farmers

41 The rural areas of the prairies had undergone some major changes. Farms had decreased dramatically in number and increased in size. (Exhibits 2 and

exhibit 2
Number of farms in Canada



3). There was an accelerating movement away from ownership of farmland and towards tenancy and part tenancy and ownership.

42 The Prairie farmer's investment in equipment was significant. A heavy duty chisel plow (33-foot cultivator) could cost about $8,600 and a 30-foot disc harrow could cost about $13,000. Four-wheel-drive tractors cost between $40,000 and $125,000 and harvesters could cost as much as $65,000. Farmers easily have $250,000 to $500,000 worth of equipment. A complete Cold-flo unit would cost a farmer about as much as the tires for his combine (see Exhibit 4).

43 Fertilizer demand over certain periods was also strongly correlated to farm incomes. Increases in fertilizer demand typically lagged one year behind increases in farm income. Small farmers especially were often reticent about purchasing new equipment. They tended to purchase equipment when they could pay cash because a poor year could leave them with bills that could not be paid. For many Alberta farmers owning modern equipment was a point of pride rather than a pure economic decision.

exhibit 3
Size of farms in Canada

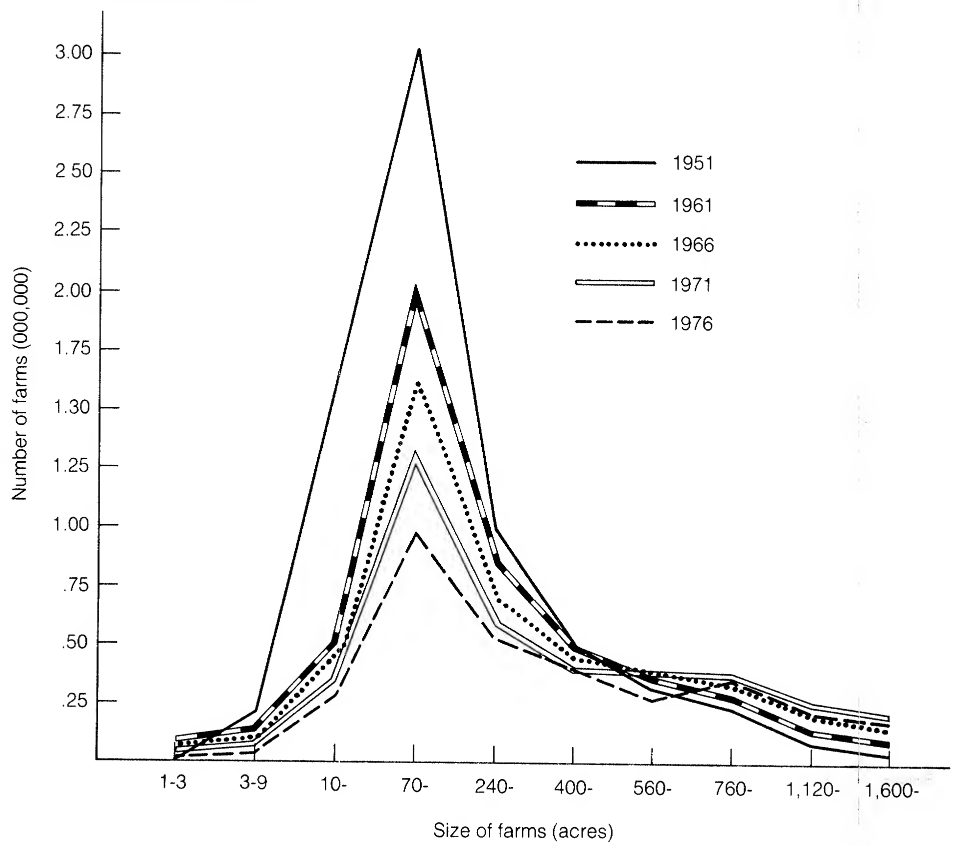


exhibit 4
Pricing of the Cold-flo system

	Price delivered to agent	*Suggested retail price*
System 16—Converter package with 16 liquid outlets	$500.00	$560.00
System 24—Converter package with 24 liquid outlets	530.00	595.00
System 32—Converter package with 32 liquid outlets. (This is a system 16 plus a flow splitter and an extra 16 outlet liquid manifold.)	660.00	745.00
System 48—Converter package with 48 liquid outlets. (This is a system 24 plus a flow splitter and an extra 24 outlet liquid manifold.)	750.00	845.00
Type 1—Liquid dispenser for field cultivator	3.25	3.65
Type 2—Combination dispenser for chisel plow	9.25	10.40
Type 3—Combination dispenser for cultivator with trailing hose (for use in difficult soil conditions)	5.65	6.35
Type 4—Vapor dispenser for field cultivator	3.25	3.65
Converter mounting stand	84.00	94.50

44 In order to convert a tillage tool to Cold-flo, a farmer would have to obtain Cold-flo equipment from an Esso agent. Some of this equipment could be made by the farmer (i.e., the converter mounting stand) or purchased from other suppliers (i.e., liquid and vapor dispensers). The Cold-flo system also required other ammonia equipment that was not normally supplied by Esso agents. This equipment included:

One ammonia flow regulator.
One breakaway quick couple for the pressurized ammonia line from the nurse tank.
Vapor hose.
Vapor system hose clamps (two per vapor line).
Liquid system hose clamps (two per liquid line).
Four U-bolts for mounting vapor manifolds to the implement frame.
Two ammonia pressure hoses.
One hitch.

45 Other Prairie companies such as Agwest, Westeel, Rosco, and Norwesco supplied hoses, regulators, and quick couples. Hose clamps and bolts were available from any hardware store.

46 The cost per ton of NH_3 would be reduced by $10 to Cold-flo users since the agent would not have to supply a conventional applicator. If a farmer already happened to own a nurse tank trailer as well, his cost per ton of NH_3 would be reduced by $20. In addition to the reduced cost of fertilizer farmers with their own applicators should be less affected by shortages in equipment during peak application periods.

The current situation

47 USS had sold about 3,000 units since the Cold-flo Converter had been introduced two years ago. USS had encountered some production constraints

and claimed that an additional 4,000 units could have been sold. Imperial had four alternatives with regard to Cold-flo:

1. Exclusive distribution through Esso agencies.
2. Marketing by Esso Chemical on a wholesale basis through the Esso agency system.
3. Nonexclusive distribution through Esso agencies.
4. Nonparticipation.

48 A preliminary testing of the Cold-flo system was done in the fall of 1977. Two units had been installed on a farm near Beiseker, Alberta. The units were reported to be running well after some modifications to the dispensers.

exhibit 5
Engro posted price history—Alberta bulk ($/ton)

Date	*82-0-0*	*34-0-0*	*46-0-0*	*21-0-0-24*
1971				
March	$150.00	$71.00	$91.50	$41.00
June	150.00	71.00	99.50	41.00
September	150.00	75.00	94.00	39.00
December	150.00	75.00	94.00	39.00
1972				
March	155.00	75.00	94.00	39.00
June	155.00	75.00	94.00	39.00
September	155.00	76.00	92.00	42.00
December	155.00	76.00	92.00	45.00
1973				
March	155.00	76.00	92.00	45.00
June	155.00	76.00	92.00	45.00
September	170.00	82.00	103.00	54.50
December	185.00	89.00	113.00	59.50
1974				
March	185.00	89.00	113.00	59.50.
June	185.00	89.00	113.00	59.50
September	215.00	100.00	135.00	75.00
December	285.00	100.00	182.00	95.00
1975				
March	255.00	135.00	169.00	95.00
June	255.00	120.00	169.00	95.00
September	265.00	132.00	175.00	93.00
December	265.00	119.50	159.00	87.00
1976				
March	280.00	122.00	159.00	75.00
June	280.00	132.00	164.00	83.00
September	260.00	122.00	159.00	74.00
December	250.00	122.00	159.00	74.00
1977				
March	270.00	125.00	159.00	79.00
June	255.00	128.00	157.00	78.00
September	240.00	122.00	152.00	78.00
December	240.00	125.00	155.00	82.00
1978				
March	260.00	136.00	169.00	85.00

49 Three units had been tested in Manitoba near Portage, Winkler (a heavy soil area that restricted the use of conventional application equipment), and Brandon. The farmers were pleased with the performance of Cold-flo. Several inquiries about the Cold-flo system were generated, including inquiries by a co-op and an Agwest dealer. A Hutterite colony near Beiseker requested two units for the spring of 1978. In total, 3,000 acres were tested. Twenty-five to 50 units had been sold for the spring of 1978.

50 The distribution of the Cold-flo system in the Prairie could have the following benefits:

1. Increased ammonia volume for Esso agents.
   a. Diversified approach (conventional applicators and Cold-flo) to serve a wider range of customer needs.
   b. Sales of Cold-flo to customers whose needs do not justify tying up the agent's applicator.
   c. Cold-flo sales may draw in potential ammonia customers.
2. Enhancement of profitable ammonia sales versus less profitable granular fertilizer sales.
3. Reduction of the required agent investment per ton of fertilizer sales.
   a. Agent could build sales volume quickly.
4. Promotion of Imperial Oil's image of progress and leadership.
   a. Innovative product.
   b. Energy and labor saving.

51 Singer wasn't certain that all of the factors involving the Cold-flo decision had been considered. Basically he wanted to know: should Imperial Oil market the Cold-flo Converter and if so, how?

case 11

Levi Strauss & Co.

1 Levi Strauss, a Bavarian immigrant who was lured to the West during the gold rush in search of prosperity, did not strike it rich in gold, but he found his fortune in jeans. His first pair of jeans was sold in 1853 to a San Francisco gold digger who wanted a sturdy pair of pants which would hold up in the mines. In time, his jeans became so popular that young Strauss set up a shop in San Francisco. Today, the headquarters of Levi Strauss & Co. (LS & Co.) stands near the same location as young Strauss's shop.

2 It was not until the 1930s that Levi's jeans reached the eastern market. Although attempts were made to promote jeans for resort wear, the basic clientele continued to be limited. World War II, however, created a sharp increase in demand, and they were sold only to individuals engaged in defense work. It also marked a turning point for Levi Strauss. LS & Co. had been largely a wholesale operation prior to World War II, but after the war, they began concentrating on manufacturing and direct sales. Before the war, LS & Co.'s annual sales were around $8 million, but by 1961, sales reached $51 million mainly because of aggressive product diversification.

3 In 1981, LS & Co. was the largest manufacturer of jeans in the world, controlling about one third of the jeans market. Additionally, they were the largest firm in the apparel industry with products in virtually every product line and sales and profits by far the greatest in the apparel industry. According to LS & Co. chairman of the board, Peter E. Haas, "We'd like to outfit people from the cradle to the grave."

4 Levi's success has resulted in part from their skill in sensing an emerging new market and responding quickly and in part from their strong management and exceptional brand name acceptance. In addition, a focus on identifying market opportunities through segmentation in recent years has aided a diversification strategy. As a result, the company's growth and success has been strong despite the extreme competitiveness and cyclical nature of the apparel industry.

5 Top managers at LS & Co. are optimistic about the 1980s. Emphasis in the future will be on expanding women's wear and activewear and increasing the international market. A 1978 assessment by *The Wall Street Transcript* is valid today. It states, "There are few firms in any industry comparable to Levi Strauss from the standpoint of dynamic growth, above-average return on equity, competitive strength, and strong international consumer franchise" (*The Wall Street Transcript*, January 23, 1978).

This case was prepared by Neil H. Snyder, Debie Alford, Karen Davis, Allison Gillum, Jim Tucker, and Jeff Walker of the McIntire School of Commerce, University of Virginia.

Key executives[1]

6 Walter A. Haas, Jr., joined the company in 1939 and served as its president from 1958 to 1970 and as its chief executive officer from 1970 to 1976. He was named chairman of the board in December 1970, and chairman of the executive committee in April 1976. He served in both of these positions until his retirement in 1981. He also served as a director since 1943. Haas controls 10.4 percent of the company's stock. This figure includes shares owned by his wife, children, estates, and trusts for which he votes. He is the great-grandnephew of Levi Strauss. He was 64 years old in November 1981.

7 Peter E. Haas joined the company in 1945 and became executive vice president in 1958. He became president of the company in December 1970, and chief executive officer in April 1976. In November 1981, he became chairman of the board. Haas controls 12 percent of the company's stock. This figure includes stock owned by his family and stock owned by trusts or estates for which he has the voting power. He graduated from the University of California in 1940 and from Harvard University's Graduate School of Business in 1943. He is the great-grandnephew of Levi Strauss and was 61 years of age in 1981.

8 Robert T. Grohman joined the company in April 1974, as president of Levi Strauss International and was elected a vice president of the company in May 1974. In 1975 he was appointed international group president and senior vice president. He has been executive vice president since April 1976 and was president of the operating groups for fiscal years 1977–1980. He was named chief member of the office of the president in June 1978. In November 1981 he became president and chief executive officer. He has served as a director since 1974. He was 56 in 1981.

9 Francis J. Brann joined the company in 1965 and was elected vice president in November 1972. He assumed the position of Levi Strauss International division area manager central Europe in June 1974 and the position of president of the Canada and Latin American divisions in January 1976. In July 1976, he was elected senior vice president and assumed the position of senior vice president, corporate planning and policy in December 1976. He was named executive vice president of the U.S. sportswear group in June 1978 and was promoted to president of Levi Strauss USA in January 1980. He joined the board of directors in July 1979. Brann graduated from the University of San Francisco in 1961 and from City College of New York, Graduate Business School in 1965. In 1981 he was 43.

10 Thomas W. Tusher joined the company in 1969. He was named president

[1] The information included in this section was obtained from "Notice of Annual Meeting of Stockholders and Proxy Statement," Levi Strauss & Co., April 2, 1980, p. 1; Standard & Poor's *Register of Corporations, Directors, and Executives*, 1980, *Directors and Executives*, vol. 2; and Standard & Poor's *Industry Surveys*, vol. 1, sec. 3, July 31, 1980, p. A95.

of Levi Strauss International in January 1980, having served as executive vice president of the International group since December 1976. During most of 1976, he held the position of president of the European division. During the previous five years, he functioned as general manager for various international divisions and areas. He was elected vice president of the company in April 1976, and senior vice president in December 1977. He joined the board of directors in July 1979. Tusher graduated from the University of California in 1963 and from Stanford University, Graduate Business School in 1965. In 1981 he was 39 years old.

11 Robert D. Haas joined the company in January 1973 as project analyst in inventory management and became Jeanswear product manager in August 1973. He then joined the Levi Strauss International group as marketing services manager in October 1975. He became director of marketing in May 1976, and assistant general manager–Far East division in December 1976. In November 1977, he was elected vice president of the company and was appointed director of corporate marketing development. He was elected senior vice president–corporate planning and policy in June 1978, and was appointed president of the New Business group in January 1980, when he joined the board of directors. In December 1980, he became president of the operating groups. In 1981, he was 38.

12 Exhibit 1 contains the names, positions, and ages of the key executives of Levi Strauss & Co.

The apparel industry

13 If one were forced to select one word which describes the nature of competition in the apparel industry, it would have to be *fierce*. In the United States alone, there are more than 15,000 manufacturers in the apparel industry. However, the industry is experiencing a trend toward consolidation (larger firms diversifying by buying smaller firms). This fact is evidenced by a 16 percent reduction in the number of domestic producers over the past five years. For the larger firms in the industry, consolidation via acquisition has led to rapid diversification of product lines and to an increased ability to cope with fluctuations in market demand. At the same time, it has resulted in market concentration. Currently, 5 percent of the firms in the apparel industry generate over 70 percent of industry sales.

14 Blue Bell, Inc. (manufacturer of Wrangler jeans), V. F. Corporation (producer of Lee jeans), and LS & Co. are the major competitors in the apparel industry in terms of sales. In 1979, Blue Bell had sales of $1.029 billion and V. F. Corporation had sales of $544 million. Sales growth in these two companies has been steady, but slow. From 1974 to 1979, Blue Bell and V. F. experienced a 17.7 percent and 8.8 percent average annual sales growth, respectively. In comparison, LS & Co. had sales of $2.1 billion in 1979, and their sales have more than doubled since 1975.

exhibit 1
Key executives

Name	*Position and office*	*Age*
J. P. Berghold	Vice president and treasurer	42
Thomas C. Borrelli	Vice president and president of the Jeanswear division	60
Francis J. Brann	Senior vice president and president of Levi Strauss USA, director	42
James W. Cameron	Vice president–human resources	49
Harry H. Cohn	Vice president and executive vice president of Group III–Levi Strauss USA, director	50
Robert T. Grohman	President, chief executive officer, director	56
Peter E. Haas	Chairman of the board, director	61
Robert D. Haas	Senior vice president and president of the operating groups, director	38
Walter H. Haas, Jr.	Retired November 1981, director	64
Thomas E. Harris	Vice president–Community affairs	
Roy C. Johns, Jr.	Vice president–corporate communications	51
Peter T. Jones	Senior vice president and general counsel, director	50
David A. Kaled	Vice president–corporate planning and policy	37
Robert B. Kern	Vice president–corporate secretary, director	60
James A. McDermott	Vice president and executive vice president of Group II–Levi Strauss USA	44
Robert F. McRae	Vice president and president of the Canada division	48
Richard D. Murphy	Vice president–controller	37
Gerald E. O'Shea	Vice president and assistant to the chief operating officer	58
Alfred V. Sanguinetti	Senior vice president and president of Group I–Levi Strauss USA, director	52
Karl F. Slacik	Senior vice president–finance and chief financial officer	51
Peter T. Thigpen	Vice president and executive vice president of Group I–Levi Strauss International	41
Thomas W. Tusher	Senior vice president and president of Levi Strauss International, director	39
William K. Warnock	Vice president, executive vice president of Diversified Apparel Enterprises and president of Koret of North America	59

Source: 10-K report for the fiscal year ended November 25, 1980, Standard & Poor's *Register of Corporation Directors and Executives* vol. 2 (1980), published by Standard & Poor's Corporation, New York.

Market saturation

15 According to Standard & Poor's, the U.S. apparel market has been saturated by both foreign and domestic producers. While imports of apparel had been growing gradually since the 1950s, in recent years imports have captured a considerable portion of the domestic market. Imports have continued to increase, albeit at a decreasing rate. Import volume doubled in the 1975 to 1978 period. Thus, domestic producers have found that it is becoming increasingly difficult to pass along to their customers the increased costs of raw materials, labor, energy, etc. In response to this trend, domestic manufacturers are turning toward mechanization, adoption of a global view of

the business, diversification toward products that are more import-resistant, and a reliance on brand name marketing and product exclusivity to counteract pressure on price.

16 Automation, particularly in the design and cutting area, is being used to increase productivity and thereby reduce cost pressures. In general, significant automation initiatives have been limited almost exclusively to the larger firms who can afford the increased investment in plant and equipment. This has resulted in even more competitive cost pressures for smaller firms which cannot afford the automated equipment. Larger firms with the resources to automate their manufacturing operations and reduce their average cost per unit will benefit through increased mechanization, but one consolation for smaller firms who choose to remain independent is that the largest cost component in production costs in the apparel industry is the cost of fabric. Thus, except for better fabric utilization, savings resulting from automation affect directly only a small proportion of total production costs. But modern equipment can reduce fabric usage. However, service centers are being set up to offer the use of automatic pattern markers to small companies on a pay-as-you-go basis. Also, by specializing in distinct niches, some small firms have avoided competition based purely on price.

Designer jeans

17 For a short time, designer jeans such as Gloria Vanderbilt, Calvin Klein, and Jordache were perceived as threats to the major producers of jeans. However, by 1981 the designer jean fad seemed to have peaked, and consumers began returning to the basic styles. Furthermore, designer jeans never accounted for more than an estimated 3 percent of the jeans market.

Counterfeiting of jeans

18 Jean counterfeiting is an emerging threat to the manufacturers of popular name brand jeans. Counterfeiting is a profitable undertaking since counterfeiters need not invest heavily to establish demand for their products (jean manufacturers have already done this), and they have no regard for product quality (jean manufacturers will bear the cost of dissatisfied customers).

19 For the most part, consumers who buy counterfeit jeans are unaware that they are not the real thing. These jeans are sold for a lower price than the "true brand," and they are often of inferior and/or inconsistent quality. Counterfeiters use lighter weight fabric; the seams in counterfeit jeans often come apart after one washing; and the zippers and rivets in counterfeit jeans are of low quality. Additionally, many counterfeiters purchase phony labels from labelmakers in New York and attach the labels to jean seconds and irregulars purchased from other jean manufacturers. Counterfeiting is a major concern for apparel manufacturers. They perceive counterfeits as a threat to their franchise as well as overall sales.

20 In 1980 alone, LS & Co. uncovered a U.S. counterfeiting operation that produced approximately 50,000 fake pairs of Levi's jeans per month. Moreover, LS & Co. recently won a $500,000 settlement in London from the operators of an international counterfeiting operation selling fake Levi's jeans in Europe. This underscores the tremendous value of Levi's trademark.

Outlook for the domestic apparel market

21 The future of the domestic apparel industry looks extremely good for various product lines such as activeware, sportswear, women's wear, jeans, and western styles. As the baby-boom population moves into a higher age bracket, emphasis on leisure remains high; the proportion of women in the work force is increasing; and the population is shifting to the Sunbelt. Thus, these segments should continue to grow.

22 Many firms who are surviving the effects of increased competition are doing so primarily because of diversification into various segments of the apparel market. By broadening their scope and focusing on different markets, firms find it easier to avoid the potentially serious negative effects resulting from rapid style changes which characterize the industry.

23 Activewear is becoming an important factor in the apparel industry, and it is expected to remain popular through the 1980s. The success of activewear is due largely to the popularity of sports and physical fitness in the United States. Additionally, activewear has both functional and fashionable qualities which make it versatile enough for use as everyday wear. Since "casual is the wave of the future" (*U.S. Industrial Outlook*, 1980; p. 367), and the refreshed, relaxed, and youthful appearance is also in vogue, the outlook for activewear is very good. Furthermore, the popularity of activewear is inducing strong growth in related sportswear apparel. LS & Co. is the only major apparel producer offering a full line of activewear.

24 Industry experts believe that women's wear has an exceptionally promising future since more women are entering the labor market. There is evidence of a strong trend toward dressier fashions, sportswear, activewear, and separates for women. This trend looks promising to the executives at LS & Co. since their recent acquisition of Koracorp Industries made them a leader in the production of women's sportswear.

25 The future of western styles looks bright also. Their popularity is expected to continue because of the trend in the United States and foreign countries toward wearing rugged American styles. From the perspective of the apparel producer, western styles are appealing for a number of reasons. First, most western-style clothes are made from cotton materials which are readily available and easy to work with. Second, they are durable, versatile, and comfortable. Thus, demand for these products is expected to remain strong for many years. Finally, corduroy products, which add color and variety to western styles, are experiencing increased demand. LS & Co. is

encouraged by this trend since they are the leading producer of western styles in the world.

The outlook for the international market

26 As the U.S. apparel market has become more saturated, growth-oriented apparel producers in the United States have directed their attention toward the market potential overseas. Between 1974 and 1979, the value of U.S. apparel exports increased from $332.7 million to $819 million. Furthermore, industry analysts believe that by 1985, four percent of total U.S. apparel production will be exported. Large U.S. apparel firms have relied on their financial, marketing, and research and development capabilities to compete successfully with foreign producers. Additionally, the popularity of American styles overseas has resulted in increased demand for name brand U.S. products.

27 Countries in Western Europe, such as Italy, Belgium, Austria, Switzerland, and West Germany, offer the most promising possibilities for future export growth. According to *U.S. Industrial Outlook* (1980, p. 367), growth prospects in these countries look good for several reasons. First, they have high standards of living. Second, they are experiencing declining domestic production. Finally, apparel imports in these countries are increasing rapidly.

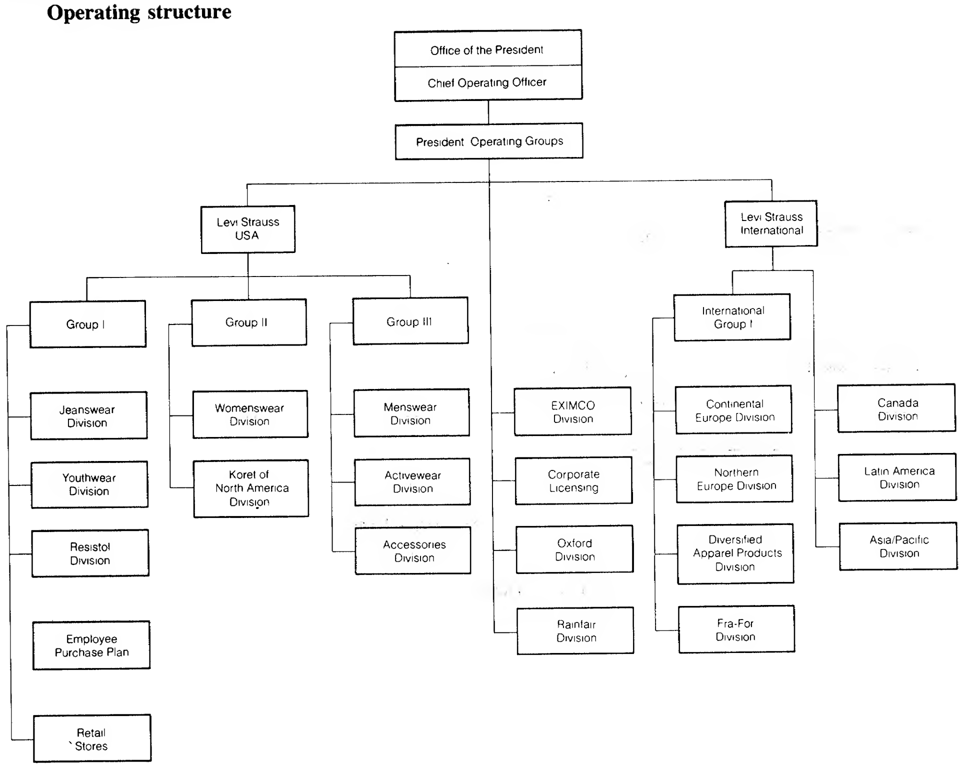
The structure and products of Levi Strauss & Co.

28 Levi Strauss & Co. designs, manufactures, and markets casual wear for just about every taste. Their product line includes everything from jeans, skirts, and suits to shoes. The majority of their products are manufactured and sold under the Levi's® trademark. In 1980, Levi Strauss & Co. consolidated its three operating divisions into two units, Levi Strauss USA and Levi Strauss International. It also has miscellaneous other divisions and a corporate staff. Each unit contains several divisions which facilitate production and marketing in various segments of the casual wear market.

Levi Strauss USA

29 Levi Strauss USA consists of three groups which are divided into 10 operating divisions: Jeanswear, Youthwear, Resistol Hats, Womenswear, Koret of North America, Menswear, Activewear, Accessories, Employee Purchase Plan, and Retail Stores. Levi Strauss & Co.'s Jeanswear division is the largest jeans manufacturer in the United States, and the largest division in the company. Additionally, it is responsible for producing all styles of jeans (i.e., straight leg, bell bottom, and prewashed). However, this group also produces various styles of shirts, jackets, vests, shorts, and western wear for men.

exhibit 2
Operating structure



30 The Youthwear division is the second major product division in the USA unit. It produces apparel for children from toddlers to teens, but it focuses primarily on the 7- to 14-year-old market. Like the Jeanswear division, its products range from jeans, jackets, shirts, and overalls to T-shirts. Sportswear for youngsters is a new product recently added to the Youthwear division.

31 Resistol Hats is the world's largest producer of brand name western and dress hats. This division was formally part of Koracorp Industries which was a large and successful manufacturer in its own right.

32 Womenswear is another important product division in the USA unit. Products included in this division include pants, shirts, sweaters, and shorts. A recent introduction to the Womenswear line, Bend-Over® pants which are made from a stretch material, is the hottest selling product in the group.

33 In the Levi Strauss & Co. 1979 annual report, the following statement was made concerning the Womenswear group: "Womenswear, the company's most rapidly growing division, nearly doubled its sales last year. . . . This sharp growth indicates the division's potential in the vast womenswear market, which exceeds the menswear in size."

34 Koret of North America division was formerly Koret of California®. They produce high brand-loyalty apparel products.

35 The Menswear division manufactures stretch pants called Levi's Action Slacks which are becoming popular. Among the other products in the Menswear division are men's shirts, vests, sweaters, and jackets.

36 Activewear is the newest product division in the USA unit. This division manufactures such products as warm-up suits, shorts, skiwear, and other sports apparel for both men and women. According to LS & Co.'s 1979 annual report, "The division's entry into the marketplace followed a three-year comprehensive study of the activewear market. . . . The activewear market was found to be large and highly fragmented, with no major American brands offering a full range of products." LS & Co.'s top managers indicate they will place substantial emphasis on activewear in the future as they attempt to carve out a niche for themselves in the market.

37 The Accessories division produces a wide range of products such as belts, hats, and wallets. The Accessories division produces the smallest sales volume of any product line in Levi Strauss & Co. Exhibit 3 shows sales figures for Levi Strauss USA from 1976 to 1980.

Levi Strauss International

38 Levi Strauss International is the second component in the company's structure. The International unit is divided into four groups (International Group I and Canada, Latin America, and Asia/Pacific divisions) of which the International Group I is the largest. The International Group I is further divided into operating divisions. LS & Co.'s primary export product is jeans, but sportswear, youthwear, and womenswear have proven to be successful export items as well.

39 Exhibit 3 shows sales figures for the International Division from 1976 to 1980.

Other operating units

40 Four operating divisions have been separated from the two main operating units (Levi Strauss USA and Levi Strauss International) due to their unique nature.

41 The EXIMCO division was set up to develop special markets for LS & Co. and to manage sales in Eastern Europe, China, Switzerland, and Hong Kong. They provide Levi Strauss with the ability to take advantage of new opportunities in international markets.

42 The Oxford Division produces top-quality men's suits in the United States, and the Rainfair division produces industrial clothing and coated compounded products for industry. Both of these divisions produce products formerly produced by Koracorp Industries.

exhibit 3

Divisions' percent of total sales ($ millions)

	1980		1979		1978		1977		1976	
	Sales	*Percent of sales*	*Sales*	*Percent of sales*	*Sales*	*Percent of sales*	*Sales*	*Percent of sales*	*Sales*	*Percent of sales*
Divisions of Levi Strauss USA:										
Jeanswear	$ 921	51%	$ 743.1	57%	$ 658.7	61%	$ 695.5	65%	$569.1	66%
Youthwear	280	16	217.8	17	184.2	17	171.6	16	126.8	15
S&A			120.7	09	120.6	11	108.8	10	94.1	11
Womenswear	290	16	197.4	15	99.2	09	62.8	06	47.4	05
Accessories	18	01	15.6	01	14.3	01	33.6	03	26.5	03
Menswear	164	09								
Koret of North America	131	07								
Total	1,804		1,294.6		1,077		1,072.3		863.9	
Levis Strauss International										
Europe	487	54	389.7	53	305.7	52	237.4	49	146.1	41
Canada	159	18	139.6	19	114.8	20	122.7	25	111.4	31
Latin America	157	18	134.7	18	103.5	18	79.3	16	51.7	15
Asia/Pacific	94	10	74.1	10	61.0	10	47.6	10	46.7	13
Total	897		738.1		585		487		355.9	

Source: 1976–1980 annual reports for Levi Strauss & Co.

Production facilities

43 Levi Strauss & Co. has numerous plants and distribution centers located in North America and throughout Asia, Latin America, and Europe. Exhibit 4 presents a list of facilities LS & Co. owns or leases. According to *Fortune* magazine (November 19, 1979, p. 86), "During the next five years, the company plans to spend some $400 million to build no fewer than 40 new factories and enlarge several existing ones; more than $250 million will go into production facilities for sweaters, blazers, and a variety of other garments that were not in the company's product line a few years ago."

exhibit 4
Facilities owned and leased

	Number of facilities	*Square feet*	*Purpose*
A. Facilities owned:			
Arkansas	1	295,000	Distribution center
	3	156,000	Manufacturing
California	3	282,000	Manufacturing
	2	323,400	Distribution center
Georgia	2	197,900	Manufacturing
Illinois	1	111,000	Manufacturing
Kentucky	1	324,200	Distribution center
Nevada	1	315,800	Distribution center
New Jersey	1	50,000	Manufacturing
New Mexico	2	189,700	Manufacturing
North Carolina	2	262,400	Manufacturing
Pennsylvania	1	126,700	Manufacturing
South Carolina	1	54,600	Manufacturing
Tennessee	9	898,900	Manufacturing
Texas	16	1,559,900	Manufacturing
	1	123,000	Curing
	2	1,399,000	Distribution center
Virginia	2	99,700	Manufacturing
Wisconsin	2	283,000	Manufacturing
Argentina	1	72,700	Manufacturing
Australia	1	103,600	Manufacturing
	1	37,000	Distribution center
Belgium	4	213,500	Manufacturing
Brazil	1	38,300	Manufacturing
	1	250,000	Manufacturing and distribution center
Canada	4	236,200	Manufacturing
	1	96,000	Manufacturing and warehousing
	1	183,000	Distribution center
France	6	317,400	Manufacturing
	1	77,200	Manufacturing and warehousing
	1	116,600	Manufacturing and distribution center
Mexico	1	253,800	Manufacturing and distribution center
	1	104,000	Manufacturing
Puerto Rico	1	54,000	Manufacturing
	1	20,000	Distribution center
Sweden	1	18,800	Distribution center
United Kingdom	3	178,000	Manufacturing
	1	96,000	Distribution center
Total	85	9,518,300	

exhibit 4 ***(concluded)***

	Number of facilities	*Square feet*	*Purpose*	*Term expires (3)*
B. Facilities leased:				
Arkansas	5	238,400	Manufacturing	1981–1989
	2	45,000	Warehousing	1982–1989
California	1	18,000	Manufacturing	1985
	1	155,000	Distribution center	2013
	2	85,000	Warehousing	1986–2001
Georgia	2	145,900	Manufacturing	1984–1996
New Mexico	2	116,000	Manufacturing	1992–1994
	1	50,300	Manufacturing and warehousing	1989
North Carolina	1	25,000	Warehousing	1984
Ohio	1	105,000	Manufacturing	2006
South Carolina	1	92,000	Manufacturing	1991
Tennessee	3	142,900	Manufacturing	1983–1998
	3	75,500	Warehousing	1982–1986
Texas	9	377,700	Manufacturing	1981–1997
	1	200,000	Manufacturing and warehousing	2009
	1	15,900	Warehousing	1983
	1	310,000	Distribution center	1998
Utah	1	29,000	Manufacturing	1993
Argentina	1	51,000	Distribution center	1982
Australia	1	83,600	Manufacturing and warehousing	1983
Belgium	1	88,300	Distribution center	1986
	1	65,000	Warehousing	1981
Canada	1	105,900	Distribution center	2002
	8	429,300	Manufacturing	1981–2002
	2	31,200	Warehousing	1981–1986
France	1	32,300	Manufacturing and warehousing	1981
	1	37,000	Distribution center	1986
Germany	1	171,800	Distribution center	1987
Hong Kong	1	93,200	Manufacturing	1982
	1	50,700	Warehousing and distribution center	1981
Italy	1	43,100	Distribution center	1983
Japan	2	26,800	Distribution center	1985
Netherlands	1	17,900	Distribution center	1985
Norway	1	11,300	Distribution center	1981
Philippines	1	38,800	Manufacturing	1984
	1	32,500	Distribution center	1984
Switzerland	1	16,800	Distribution center	1981
United Kingdom	2	116,000	Manufacturing	1999–2000
	1	144,000	Distribution center and warehousing	2000
	1	20,000	Distribution center	1981
Total	70	3,933,100		

Source: 10-K report for fiscal year-end November 25, 1980.

Marketing

44 The marketing orientation of Levi Strauss & Co. has undergone significant change since the company's inception in the 1850s. Originally, Levi's jeans were worn almost exclusively by gold miners who considered them to be essential equipment because they were both rugged and durable. However,

in the 1950s jeans became a teenage fad, and later they became a trend. Thus, LS & Co. adjusted their marketing orientation to take advantage of this trend. Currently, Levi's products are oriented toward the more fashion conscious 20- to 39-year-old age group. There are 71.1 million people in this age group in the United States today, and there will be 77.6 million people in this age group by 1985.

Brand awareness

45 LS & Co. is the leading producer in the apparel industry. Much of their success can be attributed to the marketing strength they developed over many years of producing and selling jeans. The most important competitive advantage LS & Co. has, and their most important marketing strength as well, is wide consumer acceptance of the Levi's brand. LS & Co. sells high-quality products at reasonable prices, and this fact is recognized throughout the world.

Distribution

46 LS & Co. sells most of its products through department stores and specialty outlets. In addition, they promote many accessories (i.e., belts, hats, and totebags) inside retail establishments by using attractive point-of-sale racks which compliment the products on display. Pants specialty stores began to play a more dominant role in LS & Co.'s distribution system in the early 1970s. These stores and the more broadly oriented "Levi's Only" stores represent welcomed alternatives to distributing almost exclusively through department stores where sales have been sluggish recently. Approximately 90 percent of the products sold in Levis's Only stores are manufactured by Levi.

Advertising

47 LS & Co. employs both national and local advertising, and they utilize all advertising media (i.e., TV, radio, magazines, and newspapers). LS & Co.'s promotions emphasize quality and style as the two most important attributes of their products. The slogan "quality never goes out of style" appears whenever the Levi's brand name is advertised.

48 LS & Co. maintains flexibility in their advertising programs so they can shift their emphasis to high-volume markets quickly. They focus on anticipating consumer demand and gearing their advertising accordingly rather than attempting to dictate consumer preferences. Furthermore, they employ advertising programs which parallel and compliment their special selling support.

Other marketing strengths

49 *Diversification.* Levi's extensive diversification is a major strength. They offer a wide variety of products to consumers throughout the United States and the world. This diversity makes LS & Co. less vulnerable to dramatic shifts in consumer preferences for any particular product or in any particular place.

50 *Dependable delivery.* LS & Co. employs an advanced computer system to define fashion trends and anticipate changes in consumer demand for apparel. This system enables LS & Co. to manufacture and inventory products which are selling well or are expected to sell well. Thus LS & Co. has achieved a reputation for dependable delivery.

51 *Market research.* When Levi Strauss develops a new product, they utilize test marketing to determine the most effective approach for advertising it. They concentrate on understanding the nature of demand for the product by identifying trends which might affect that demand and determining if that demand can be serviced. First, they segment the markets they serve according to consumers preferences and the types of retail outlets which serve them. Then, they identify locations where the Levi's brand has achieved acceptance. Thus, LS & Co. adjusts its advertising to meet the needs of specific products in specific markets.

Marketing weaknesses

52 Despite their numerous marketing strengths and their number one position in the apparel industry, LS & Co. has marketing weaknesses as well. First, their pricing policy is subject to Federal Trade Commission (FTC) regulations. Specifically, the FTC does not permit forced price maintenance by manufacturers at the retail level. In recent years, this has cost LS & Co. millions of dollars for out-of-court settlements of cases in which they were accused of price maintenance. As a result, LS & Co. is susceptible to price wars. Retailers will drastically cut the price of Levi's products to attract customers to their stores from their competitors. This may pose a possible threat to the quality image of a branded product.

Personnel

53 The apparel industry employs approximately 1,134,000 production workers, and employment in the industry has been stable for five years. Heavy concentrations of jobs in the apparel industry are found in New York, Pennsylvania, California, North Carolina, and Texas, but most production is done in the South due to the low cost of labor.

54 Apparel production is highly labor intensive, and apparel industry wages are among the lowest of all manufacturing industries. This is because the production process used by apparel firms is suited to employing unskilled

and semiskilled workers. Two major unions represent apparel workers (International Ladies Garment Union and Amalgamated Clothing and Textile Workers Union), and 81 percent of workers in the apparel industry are women.

55 LS & Co. employed over 44,700 individuals in 1979. Seventy-five percent (75 percent) of them were production workers, and over 60 percent of LS & Co. production workers were union members. Relations between LS & Co. and the production workers are satisfactory. As evidence of this fact, there has never been a major interruption in production due to labor disputes.

56 At LS & Co., in 1979, 11 percent of officials and managers were minority persons; 15 percent of officials and managers and 4 percent of sales personnel were women; and the board of directors includes both minority persons and women. Further, LS & Co. supports minority economic development, and management's community concern is evidenced by its objective of allocating at least 3 percent of aftertax profits to social responsibility efforts. All LS & Co. plants have strong community relations programs, and LS & Co. encourages all employees to be socially concerned and socially active.

Research and development

57 Research is considered one of LS & Co.'s most important competitive advantage. Their product research and development department is responsible for the company's progress in new fabrics and garments, and their goal is to improve functional performance. Additionally, an Equipment Research and Development Center is maintained by LS & Co. so that it can remain a leader in automated and semiautomated production equipment. Further, corporate marketing research has an online computerized data bank to monitor major fashion directions, general apparel pricing, retail point-of-sale trends, the company's image, and consumer attitudes toward products currently offered. Research also pretests the effectiveness of proposed advertisements and receptivity of the marketplace to new products.

Financial matters at Levi Strauss & Co.

58 Exhibits 5, 6, 7, and 8 present LS & Co.'s 10-year financial summary, consolidated income statement, consolidated balance sheets, and consolidated statement of changes in financial position, respectively.

Future

59 At LS & Co. the word *future* means diversification. In November of 1977, LS & Co. began a coordinated corporate strategy of diversification which it intends to continue into the future "at full speed." Four facts suggest this course of action:

exhibit 5

LEVI STRAUSS & CO. AND SUBSIDIARIES
Ten-Year Financial Summary
For the Years Ended 1971–1980
($ millions except per share amounts)

	1980	*1979*	*1978*
Net sales	$2,840.8	$2,103.1	$1,682.0
Gross profit	1,040.2	793.8	623.6
Interest expense	25.0	12.4	11.2
Income before taxes	401.9	345.6	280.4
Provision for taxes on income	178.2	154.1	135.4
Net income	223.7	191.5	145.0
Earnings retained in the business	170.2	151.1	110.0
Cash flow retained in the business*	213.3	176.9	125.5
Income before taxes as percent of sales	14.1%	16.4%	16.7%
Net income as percent of sales	7.9	9.1	8.6
Net Income as percent of beginning Stockholders' equity	32.8	33.3	31.3
Current assets	1,122.5	1,047.1	824.2
Current liabilities	452.4	489.7	302.4
Working capital	670.1	557.4	521.8
Ratio of current assets to current liabilities	2.5/1	2.1/1	2.7/1
Total assets	1,455.4	1291.1	973.9
Long-term debt—less current maturities	138.8	99.1	83.3
Stockholders' equity	831.6	681.2	575.3
Capital expenditures	119.8	51.3	42.9
Depreciation	25.4	18.2	16.1
Property, plant and equipment—net	280.8	188.5	141.3
Number of employees	48,000	44,700	35,100
Per share data:			
Net income	5.36	4.58	3.28
Cash dividends declared	1.30	1.00	.80
Book value (on shares outstanding at year-end)	20.34	16.50	13.14
Market price range	44–30	34½–17	19⅜–13⅝
Average Common and common equivalent shares outstanding	41,763,108	41,784,058	44,229,872

*Working capital provided by operations minus dividends declared.
Source: 1980 annual report for Levi Strauss & Co.

1. "In all probability the jeans business in the United States is slowly maturing" (*Business Week*, May 19, 1979).
2. LS & Co. is generating more cash than it needs to finance its 20 percent annual growth in jeans.
3. Market research shows better returns could be made by putting the Levi's® trademark or name on other products.
4. In all likelihood, antitrust laws would block an attempt by LS & Co. to acquire another jeans maker.

1977	*1976*	*1975*	*1974*	*1973*	*1972*	*1971*
$1,559.3	$1,219.7	$1,015.2	$897.7	$653.0	$504.1	$432.0
562.6	439.9	347.4	275.5	184.4	160.3	129.6
20.0	12.2	13.1	13.7	10.1	4.3	4.4
270.0	206.8	136.7	72.7	33.8	48.1	35.7
140.2	102.1	71.9	37.9	22.0	23.0	16.0
129.8	104.7	64.7	34.9	11.9	25.0	19.7
108.0	94.8	58.6	29.6	6.6	20.9	16.3
128.7	110.6	71.7	45.7	17.7	28.6	22.5
17.3%	17.0%	13.5%	8.1%	5.2%	9.5%	8.3%
8.3	8.6	6.4	3.9	1.8	5.0	4.6
35.8	39.5	31.4	19.8	7.0	16.8	23.2
694.2	570.1	407.6	383.5	305.5	252.4	202.8
263.5	226.6	155.4	188.1	155.7	98.2	67.9
430.7	343.5	252.2	195.3	149.8	154.2	134.9
2.6/1	2.5/1	2.6/1	2.0/1	2.0/1	2.6/1	3.0/1
824.2	678.0	496.1	470.4	382.7	307.1	297.9
80.6	79.2	68.7	72.2	48.1	37.6	28.4
463.9	362.4	265.2	206.0	176.4	168.7	148.8
31.4	19.5	10.4	24.3	28.8	17.6	15.6
13.7	11.6	9.3	9.7	8.3	6.4	5.1
119.3	102.4	82.1	82.3	68.0	48.0	39.6
37,200	32,500	29,700	30,100	29,100	25,100	21,400
2.93	2.35	1.47	.80	.27	.57	.47
.50	.23	.14	.12	.12	.10	.08
10.66	8.25	6.08	4.73	4.05	3.90	3.42
15⅞–12⅛	13⅜–9	10¾–3⅛	5⅝–3⅛	12½–4¼	15–10⅛	16⅛–8⅜
44,257,346	44,476,748	43,899,028	43,520,320	43,520,320	43,520,320	42,344,000

Peter Haas, chairman of the board, states "diversification has become the most prudent course we can follow."

60 *Fortune Magazine* (November 19, 1978) foresees two dangers in LS & Co.'s diversification plans. "One danger inherent in these ambitious plans is that keeping track of all the ever-changing fashions and maintaining the huge assortment of sizes and styles in all the new fields could tax the company's managerial capabilities beyond their limits." Also, LS & Co. is "vulnerable to the same profit-eroding markdowns the minute inventories get out of hand."

exhibit 6

LEVI STRAUSS & CO. AND SUBSIDIARIES
Consolidated Statement of Income
For the Years 1978–1980
($000 except per share amounts)

	Year ended		
	November 30, 1980 (53 weeks)	*November 25, 1979 (52 weeks)*	*November 26, 1978 (52 weeks)*
Net sales	$ 2,840,844	$ 2,103,109	$1,682,019
Cost of goods sold	1,800,665	1,309,263	1,058,439
Gross profit	1,040,179	793,846	623,580
Marketing, general, and administrative expenses	635,870	464,086	344,536
Operating income	404,309	329,760	279,044
Interest expense	25,018	12,449	11,178
Interest and other income, net	(22,606)	(28,238)	(12,503)
Income before taxes	401,897	345,549	280,369
Provision for taxes on income	178,208	154,095	135,400
Net income	$ 223,689	$ 191,454	$ 144,969
Net income per share	$ 5.36	$ 4.58	$ 3.28
Average common and common equivalent shares outstanding	41,763,108	41,784,058	44,229,872

Source: 1980 annual report for Levi Strauss & Co.

61 Robert T. Grohman, president and chief executive officer, says, "In order to maintain something close to the rate of growth we have experienced in the last five years, we are looking at much more rapid expansion in other segments." He adds, "We are not a fringe house and we are not high-fashion innovators, but we are looking at product lines that have a long-term appeal to the mainstream consumer." Furthermore, Grohman says, "Our size and diversification give us tremendous flexibility."

62 Brenda Gall of Merrill Lynch, Pierce, Fenner & Smith says of LS & Co., "They have instant name recognization, strong ties with retailers, and the marketing talent to identify and go after basic, profitable product lines. They have many opportunities ahead of them, and their growth rate over the last five years is not unsustainable."

exhibit 7

LEVI STRAUSS & CO. AND SUBSIDIARIES
Consolidated Balance Sheets
For the Years 1979 and 1980
($000)

	November 30, 1980	November 25, 1979
Assets		
Current assets:		
Cash	$ 36,192	$ 27,454
Temporary investments of cash	51,693	195,297
Trade receivables (less allowance for doubtful accounts: 1980–$9,368; 1979–$8,340)	446,461	340,131
Inventories:		
Raw materials and work-in-process	275,538	216,820
Finished goods	275,017	225,001
Other current assets	60,606	42,411
Total current assets	1,122,507	1,047,114
Property, plant, and equipment (less accumulated depreciation: 1980–$113,301; 1979–$101,989)	280,783	188,495
Other assets	52,050	55,510
Total assets	$1,455,360	$1,291,119
Liabilities and Stockholders' Equity		
Current liabilities:		
Current maturities of long-term debt	$ 14,963	$ 15,832
Short-term borrowings	48,642	53,535
Accounts payable	135,006	154,929
Accrued liabilities	93,875	83,802
Compensation and payroll taxes	55,313	57,636
Pension and profit sharing	20,982	27,545
Taxes based on income	68,309	85,069
Dividend payable	15,335	11,357
Total current liabilities	452,425	489,705
Long term debt—less current maturities	138,754	99,126
Deferred liabilities	32,552	21,098
Stockholders' equity:		
Common stock—$1 par value: authorized 100 shares; shares issued—1980—43,998,808, 1979—21,999,404	43,999	21,999
Additional paid-in capital	59,837	82,424
Retained earnings	806,257	636,010
Total paid-in capital and retained earnings	910,093	740,433
Less treasury stock, at cost: 1980—3,105,482 shares: 1979—1,354,949 shares	78,464	59,243
Total stockholders' equity	831, 29	681,190
Total liabilities and stockholders' equity	$1,455,360	$1,291,119

exhibit 8

LEVI STRAUSS & CO. AND SUBSIDIARIES
Consolidated Statement of Changes in Financial Position
For the Years 1978–1980
($000)

	Year ended		
	November 30, 1980 (53 weeks)	*November 25, 1979 (52 weeks)*	*November 26, 1978 (52 weeks)*
Working capital provided by:			
Operations			
Net income:	$ 223,689	$ 191,454	$144,969
Add items not currently involving working capital:			
Depreciation and amortization	30,004	20,430	17,606
Other, net	13,066	5,380	(2,140)
Working capital provided by operations	266,759	217,264	160,435
Common stock issued in acquisition of Koracorp Industries Inc.	—	37,261	—
Proceeds from long-term debt	54,586	8,400	14,411
Common stock issued to employees	6,322	4,999	5,077
Total working capital provided	327,667	267,924	179,923
Working capital used for:			
Additions to property, plant, and equipment	119,824	51,254	42,863
Cash dividends declared	53,442	40,391	34,972
Acquisition of Koracorp Industries Inc. (less working capital of $34,961):			
Property, plant, and equipment	—	17,702	—
Other assets	—	4,885	—
Goodwill	—	39,341	—
Long-term liabilities assumed	—	(26,054)	—
Purchases of treasury stock	26,130	87,451	3,611
Reductions in Long-term debt	14,958	15,505	11,766
Other, net	640	1,862	(4,379)
Total working capital used	214,994	232,337	88,833
Net increase in working capital	$ 112,673	$ 35,587	$ 91,090

Increase (decrease) in working capital, represented by change in:			
Cash and temporary investments of cash	$(134,866)	$ (32,070)	$ 93,880
Trade receivables, net	106,330	99,006	37,886
Inventories	85,734	143,327	4,391
Other current assets	18,195	12,624	(6,188)
Current maturities of long-term debt and short-term borrowings	5,762	(48,003)	20,290
Accounts payable and accrued liabilities	9,850	(83,667)	(51,983)
Other current liabilities	21,668	(55,630)	(7,186)
Net increase in working capital	$ 112,673	$ 35,587	$ 91,090

Source: 1980 annual report for Levi Strauss & Co.

case 12

Ashland Oil, Inc.

1 "You hear a lot about making big money in oil and gas exploration, but the truth of the matter is that it's a lousy business." So spoke Orin E. Atkins, chairman of the board and chief executive officer of Ashland Oil, Inc. The time was June 1978 and Atkins had recently announced that he was trying to sell Ashland's entire exploration and production business, including its foreign interests.

2 To auction away an oil firm's reserves, which many consider to be the heart of the business, was not looked upon by many with favor. One industry observer, for example, commented that it was "like throwing your wife into the street."[1] Nonetheless, that is exactly what Orin E. Atkins set out to do.

Company history

3 The corporate history of Ashland Oil, Inc., could be traced back to the Swiss Oil Corporation. The Swiss Oil Corporation was incorporated in Kentucky on June 21, 1918. In 1925, it acquired the producing properties of Union Gas and Oil Company, also located in Kentucky. The latter owned 95 percent of the capital stock of the Ashland Refining Company which had been organized in Kentucky in February of 1924. In October of 1931, the Ashland Refining Company organized the Ashland Oil & Transportation Company to acquire the pipeline properties of Cumberland Pipeline Company. Soon the little refinery was making more money than Swiss Oil. Ashland Oil and Refining Company was incorporated in Kentucky on October 31, 1936 as a consolidation of Swiss Oil and its subsidiary, Ashland Refining Company. Since then the company had been run with two objectives: operations and acquisitions. With acquisitions, more and more refining capacity, pipelines, and crude oil sources were added. By the 1960s, Ashland, no longer a little guy, was widely considered as one of the larger oil companies. Its present name was adopted on February 2, 1970. (See Exhibit 1 for financial statements and Exhibits 2 and 3 for acquisitions and subsidiaries.)

4 While chemical interests had been added in the 1950s, it was only in the last 1960s and early 1970s that Ashland truly diversified. It acquired O. K. Tire and Rubber with over 900 franchised stores; Warren Brothers, a leading highway contractor; Catalin Corporation, a producer of synthetic resins; Fisher Chemicals; and ADM Chemicals. In 1969, Arch Mineral Corporation (a 49 percent owned affiliate of Ashland Coal) was created.

This case was prepared by Deepak Rai and Charles E. Curtis under the supervision of M. Edgar Barrett of Southern Methodist University. Copyright © 1980 by Mr. Edgar Barrett. Reproduced by permission.

[1] "Ashland Oil: Getting Out of Crude as It Sheds Lackluster Operations," *Business Week*, September 4, 1978, p. 90.

exhibit 1

Financial statements

ASHLAND OIL, INC.
Statement of Consolidated Income
For the Years Ended September 30, 1975–1979
($000)

	1979	*1978*	*1977*	*1976*	*1975*
Revenues:					
Sales and operating revenues	$6,740,363	$5,426,167	$5,051,893	$4,406,714	$3,924,273
Equity income	16,619	13,214	12,287	13,796	16,224
Gain on sale of operations	505,714	193,094	—	—	—
Interest and other income	82,759	42,451	40,231	38,330	38,895
Total revenues	7,345,455	5,674,926	5,104,411	4,458,840	3,979,392
Costs and expenses:					
Operating and general					
Raw materials, products, services, and supplies	5,490,000	4,118,993	3,770,293	3,243,681	2,906,710
Salaries, wages, and employee benefits	512,494	526,854	463,675	409,168	363,105
Dry hole costs	6,929	8,470	14,537	11,325	19,607
Taxes other than income					
Product and property	29,119	31,248	26,782	20,924	19,409
Payroll	29,808	29,235	25,697	24,289	22,380
Excise	266,496	259,516	266,315	261,463	244,760
Noncash charges					
Depreciation, depletion, and amortization	134,153	174,526	151,720	133,456	109,709
Reserve for exploration costs in foreign areas	—	—	13,921	11,744	6,911
Interest expense	75,903	82,180	69,256	59,389	54,717
Total costs and expenses	6,544,902	5,231,022	4,802,196	4,175,439	3,747,308
Income before income taxes	800,553	443,904	302,215	283,401	232,084
Income taxes:					
Federal and state	76,451	97,361	83,726	87,727	60,529
U.S. investment tax credit	(22,094)	(14,490)	(17,970)	(13,063)	(6,879)
U.S. deferred	38,919	(1,908)	36,397	25,832	25,685
Foreign current	25,818	40,588	36,154	39,742	34,266
Foreign deferred	865	2,194	(357)	1,868	4,469
Tax on gain on sale of operations	154,341	75,385	—	—	—
Total taxes	274,300	199,130	137,950	142,106	118,070
Net income	$ 526,253	$ 244,774	$ 164,265	$ 141,295	$ 114,014

exhibit 1 ***(continued)***

ASHLAND OIL, INC.
Statement of Changes in Consolidated Financial Position
For the Years Ended September 30, 1975–1979
($000)

	1979	*1978*	*1977*	*1976*	*1975*
Working capital was provided from:					
Operations					
Net income	$ 526,253	$244,774	$164,265	$141,295	$114,014
Add expenses (income) not affecting working capital in the current year:					
Depreciation, depletion, and amortization (includes capitalized leases)	138,117	162,537	141,998	120,298	105,738
Write-off or amortization of exploration costs	(3,203)	14,630	11,442	14,493	3,698
Valuation loss on VLCC	—	31,925	—	—	—
Deferred income taxes	2,780	286	36,040	27,700	30,154
Equity income (net of dividends)	(10,384)	(8,221)	(7,974)	(11,309)	(13,166)
Working capital provided from operations	653,563	445,931	345,771	292,477	240,438
Increase in long-term debt	150,392	109,710	314,820	13,038	79,620
Other long-term liabilities	6,180	19,869	3,040	(2,315)	(16,012)
Increase in minority interests	—	6,410	1,589	1,659	520
Issuance of capital stock	—	—	65,874	—	—
Net book value of property disposals	33,031	12,858	16,141	30,299	36,330
Noncurrent net assets of operations sold	335,582	86,643	—	—	—
Total working capital provided	1,178,748	681,421	747,235	335,158	340,896
Working capital was used for:					
Cash dividends	69,469	68,657	63,160	51,501	45,566
Property, plant, and equipment including properties acquired from other companies	292,184	317,318	500,819	255,627	279,961
Payments and current portions of long-term debt and capitalized leases	208,772	201,952	141,972	33,104	35,004
Purchase and retirement of common stock	560,941	—	—	—	—
Redemption of preferred stock	5,000	—	—	—	—
Investments, prepaid royalties, and other—net	2,062	8,639	19,923	6,822	4,171
Total working capital used	1,138,428	596,566	725,874	347,054	364,702
Increase (decrease) in working capital	$ 40,320	$ 84,855	$ 21,361	$(11,896)	$(23,806)

exhibit 1 ***(continued)***

ASHLAND OIL, INC.
Consolidated Balance Sheet
For the Years Ending September 30, 1975–1979
($000)

	1979	*1978*	*1977*	*1976*	*1975*
Assets					
Current assets:					
Cash	$ 35,681	$ 42,079	$ 55,544	$ 50,088	$ 83,271
Short-term securities	625,517	33,856	37,296	75,353	59,838
Receivable from sale of Ashland Oil Canada Limited	—	315,840	—	—	—
Accounts receivable (less reserve)	652,436	540,737	479,101	416,486	403,717
Construction completed and in progress, at contract prices	47,468	77,197	54,895	43,631	32,250
Inventories:					
Crude oil	141,166	131,667	165,013(1)	111,430	84,649
Petroleum products	96,701	99,691	119,899(1)	78,019	78,530
Chemicals and other products	101,754	105,579	109,906	95,405	98,565
Materials and supplies	23,744	30,987	35,514	39,199	41,922
Prepaid expenses	28,614	21,307	21,344	18,546	28,712
Total current assets	1,753,081	1,398,940	1,078,512	928,157	911,454
Investments and other assets:					
Investments in and advances to unconsolidated subsidiaries and affiliates	108,726	97,218	81,597	81,497	73,052
Notes and other receivables	12,895	19,625	25,507	22,990	21,112
Other assets, prepaid royalties, and deferred charges	58,173	56,477	49,541	29,275	27,313
Total investments and other assets	179,794	173,320	156,645	133,762	121,477
Property, plant, and equipment (net):					
Petroleum	722,327	641,959	596,636	491,922	426,404
Chemical	118,627	142,918	130,971	119,479	106,737
Coal	112,965	102,586	89,093	21,338	23,758
Construction	108,265	145,465	141,435	128,984	120,992
Exploration	43,625	390,888	374,779	260,362	263,688
Canada	—	—	157,045	126,638	114,769
Other	74,530	42,241	52,403	55,262	52,828
Total property, plant, and equipment	1,180,339	1,466,057	1,542,362	1,203,985	1,109,176
Total assets	$3,113,214	$3,038,317	$2,777,519	$2,265,904	$2,142,107

exhibit 1 *(continued)*

Consolidated Balance Sheet *(continued)*

Liabilities, Redeemable Preferred Stock, Common Stock, and Other Stockholders' Equity	*1979*	*1978*	*1977*	*1976*	*1975*
Current liabilities:					
Short-term debt	$ 16,949	$ 68,036	$ 16,573	$ —	$ —
Accounts payable	858,596	549,591	544,789	438,892	444,491
Accrued taxes other than income and excise taxes	22,241	19,919	18,012	15,150	14,272
Accrued interest	12,960	14,688	11,686	6,663	6,333
Excise taxes	17,475	14,356	23,799	22,378	25,122
Income taxes	300,948	129,929	56,079	74,103	30,491
Current portion of long-term debt and capitalized leases	27,039	145,868	35,876	20,634	28,512
Total current liabilities	1,256,208	942,387	706,814	577,820	549,221
Long-term debt—less current portion:					
Senior debt	391,985	512,559	612,226	449,991	452,814
Subordinated debt	26,292	59,233	72,470	52,998	60,000
Total long-term debt	418,277	571,792	684,696	502,989	512,814
Capitalized lease obligations—less current portion	180,746	188,075	194,105	201,450	212,113
Other long-term liabilities	76,228	70,048	35,731	34,205	36,529
Deferred income taxes	118,841	116,055	169,477	129,876	102,176
Minority interests in consolidated subsidiaries	—	—	23,963	22,374	20,714
Redeemable preferred stock:					
$2.40 convertible preferred series of 1966	—	—	—	8,183	23,729
$5 convertible preferred series of 1969	—	1,053	1,053	1,053	1,053
$2.40 convertible preferred series of 1970	—	1,219	1,234	2,059	2,127
$5 convertible preferred series of 1970	8	184	185	185	185
Cumulative preferred stock, 8.375% series of 1974	45,000	50,000	50,000	50,000	50,000
Cumulative preferred stock, 8.50% series of 1976	50,000	50,000	50,000	—	—
Stated value	95,008	102,456	102,472	61,480	77,094
Excess of redemption value over stated value	405	96,407	96,854	120,825	122,902
Total redeemable preferred stock	95,413	198,863	199,326	182,305	199,996
Common stock and other stockholders' equity:					
Common stock—par value $1 per share	30,576	27,841	27,390	25,856	25,084
Paid-in capital	105,083	148,398	148,269	128,360	117,262
Retained earnings	835,255	874,254	687,591	586,935	494,540
Shares in treasury at cost and excess of redemption value over stated value of preferred stock	(3,413)	(99,396)	(99,843)	(126,266)	(128,342)
Total common stock and other stockholders' equity	967,501	951,097	763,407	614,885	508,544
Total liabilities, redeemable preferred stock, common stock, and other stockholders' equity	$3,113,214	$3,038,317	$2,777,519	$2,265,904	$2,142,107

exhibit 1 ***(concluded)***

ASHLAND OIL, INC.
Revenue and Income by Line of Business
For the Years Ended September 30, 1975–1979
($000)

	1979	*1978*	*1977*	*1976*	*1975*
Revenues:					
Sales and operating revenues					
Petroleum	$4,922,093	$3,560,788	$3,412,807	$2,867,052	$2,583,014
Chemical	1,016,510	882,940	802,316	723,708	622,825
Coal	159,147	139,711	109,180	5,839	1,022
Construction	797,879	760,291	628,812	618,155	545,267
Exploration	178,018	206,913	186,653	181,917	145,019
Canada	—	228,101	218,454	194,229	173,531
Intersegment sales	(333,284)	(352,577)	(306,329)	(184,186)	(146,405)
Total sales and operating revenues	6,740,363	5,426,167	5,051,893	4,406,714	3,924,273
Other:					
Gain on sale of operations	505,714	193,094	—	—	—
Equity income	16,619	13,214	12,287	13,796	16,224
Other	82,759	42,451	40,231	38,330	38,895
Total revenues	7,345,455	5,674,926	5,104,411	4,458,840	3,979,392
Income before income taxes:					
Operating income					
Petroleum	$ 203,710	$ 158,777	$ 223,520	$ 221,671	$ 180,776
Chemical	69,719	38,946	22,662	12,604	11,363
Coal	12,258	16,552	13,627	2,410	2,719
Construction	22,889	41,722	35,165	40,098	37,147
Exploration	56,437	71,513	51,121	39,099	35,502
Canada	—	52,808	40,989	25,951	24,076
Other	(2,856)	(29,872)	(6,842)	(5,441)	(11,731)
Total income before income taxes	362,157	350,446	380,242	336,392	279,852
Other income					
Gain on sale of operations	505,714	193,094	—	—	—
Equity income	16,619	13,214	12,287	13,796	16,224
Interest expense	(75,903)	(82,180)	(69,256)	(59,389)	(54,717)
Other (net)	(8,034)	(30,670)	(21,058)	(7,398)	(9,275)
Total income	$ 800,553	$ 443,904	$ 302,215	$ 283,401	$ 232,084

Source: Ashland Oil, Inc., 1979 financial and operating supplement.

exhibit 2
Major acquisitions and divestments

Date	Selling firm	Business sector
	Major Acquisitions	
1939	Owensboro-Ashland	Operated cruide gathering lines
1948	Allied Oil Company	Production, refining, transportation, and marketing
1963	Union Carbon Company	Oil and gas production
1966	O.K. Tire and Rubber Company	Marketer of tires, manufacturer of tread rubber
	Warren Brothers Co., Inc.	Paving and highway construction
	Fisher Chemical Co., Inc.	Chemical operations
	Catalin Corporation	Synthetic resins
1967	Archer-Daniels-Midland Co.	Chemical operations
1968	Wanda Petroleum Co., Inc.	Liquid petroleum gas operations
	New Haven Trap Rock Co.	Quarrier of trap rock, road construction
	F. H. Ross Co.	Chemicals
1970	Canadian Gridoil Ltd.	Oil and gas production
	Northwestern Refining Co.	Oil refining, marketing, and transportation
1971	Macasphalt Corp.	Construction
	Eastern Seaboard Petroleum Co.	Marketer of distillates and heavy fuel oils
	Union Carbide Petroleum Corp.	Domestic and Foreign oil and gas properties
1972	Reno Construction	Road paving and construction materials
1972	Empire State Oil Co.	Oil and gas exploration and production
1975	Levingston Shipbuilding Co.	Manufactures marine equipment
1976	Coastal Chemical Co.	Chemicals
	General Oils, Inc.	Oil and gas exploration and production
1977	Fil Nutter Coal Operations	Coal
	Nielsons, Inc.	Heavy construction firm
	Chemical Supply Co.	Chemicals
1978	Maxwell Bridge Co., Inc.	Construction
	Ted Wilkerson, Inc.	Construction
	Major divestments	
1970	American Independent Oil Co.	Oil and gas exploration and production
1972	Wanda Petroleum Co., Inc.	Liquid petroleum gas operations
1978	Ashland Oil Canada, Ltd.	Oil and gas exploration and production
	Operation of Ashland Chemical Co.	Coating resins business
1979	Chemical Products Division of Ashland Chemical Co.	Chemical products
	Majority of foreign and domestic exploration and production operations	Oil and gas exploration and production

Principal businesses in 1979

5 **Petroleum division.** The petroleum division had the responsibility for the supply and transportation of the crude oil requirements for Ashland's seven refineries, and for marketing, transportation, and storage of refined petroleum products for sale outside the company (see Exhibit 4 for petroleum statistics).

exhibit 3

Principal subsidiaries, September 30, 1979

Arch Mineral Corporation (50 percent)
Ashland Coal, Inc.
Ashland Exploration, Inc.
Ashland Indonesia Co.
Ashland Oil Enterprises, Inc.
Ashland Oil Holdings, Inc.
Ashland Oil Investments, Inc.
Ashland Oil and Refining Co.
Ashland Oil and Transportation Co.
Ashland Petroleum International, Inc.
Ashland Synthetic Fuels, Inc.
Ashland-Warren, Inc.
Levingston Shipbuilding Co.
Nielsons, Inc.
O.K. Tire and Rubber Co., Inc.
SuperAmerica Stations, Inc.
Valvoline Oil Co.
Valvoline Oil and Chemicals Ltd.

Source: Ashland Oil, Inc., form 10-K, 1979.

exhibit 4

Petroleum statistics

	1979	*1978*	*1977*	*1976*	*1975*
Petroleum Manufacturing					
Crude oil refining capacity (barrels per stream day)	475,000	395,000	395,000	395,000	395,000
Crude oil refined (barrels per day, segregated by original source of crude)					
United States	108,852	119,650	112,666	140,224	138,640
Canada	34,568	32,825	54,433	67,185	83,884
Foreign	224,322	200,477	191,127	140,748	108,366
Total	367,742	352,952	358,226	348,157	330,890
Average crude oil cost (per barrel)	$ 17.44	$ 14.04	$ 13.49	$ 12.64	$ 11.55
Less entitlements	(.88)	(.80)	(1.06)	(1.12)	(.58)
Net crude oil cost	$ 16.56	$ 13.24	$ 12.43	$ 11.52	$ 10.97
Product realization	$ 21.39	$ 16.42	$ 15.55	$ 14.01	$ 13.39
Product manufactured:					
Gasoline and jet fuel	54.4%	56.8%	55.2%	54.9%	53.5%
Kerosene and distillate	24.5	23.0	24.2	24.6	25.1
Heavy fuel oil	9.0	9.4	10.1	9.7	10.5
Asphalt	8.3	7.8	6.4	6.1	6.4
Other	3.8	3.0	4.1	4.7	4.5
Total	100.0%	100.0%	100.0%	100.0%	100.0%
Petroleum marketing (barrels per day):					
Gasoline and jet fuel	233,344	226,655	226,433	221,208	204,945
Kerosene and distillate	95,308	96,437	97,978	93,819	84,121
Heavy fuel oil	145,930	132,866	144,785	130,386	129,571
Asphalt	30,791	29,190	25,690	24,323	22,551
Other	25,162	23,656	22,013	22,510	20,343
Total	530,535	508,804	516,899	492,246	461,531

Source: Ashland Oil, Inc. annual report, 1979.

6 The company's principal refineries were modern, efficient facilities. They included crude oil atmospheric and vacuum distillation units, fluid catalytic cracking units and desulfurization units. One of the refineries, the Findlay refinery, produced largely asphalt. It operated on a seasonal basis, as the producing and marketing of asphalt were concentrated in the period from April to October. Asphalt was also produced at Ashland's other five refineries. The Catlettsburg and Buffalo refineries were also equipped to manufacture a wide range of petrochemicals (see Exhibits 5 and 6 for refinery statistics and geographic locations).

7 Ashland's seven refineries were concentrated around the highly industrialized Ohio Valley. As one company official put it, "They're in the marketplace, not in Houston."[2] Further, Ashland's refineries used almost 5 percent less energy per barrel than the average refinery. Since fuel costs were one of the highest operating costs of refining, this represented a sizable saving. Robert Yancey, Ashland's president, explained the reason for this as being, "We built our refineries in a northern climate where we *had to* conserve heat—another factor was that we never had the low cost of natural gas used as fuel by the refiners in the big producing states. . . . I'd spot the

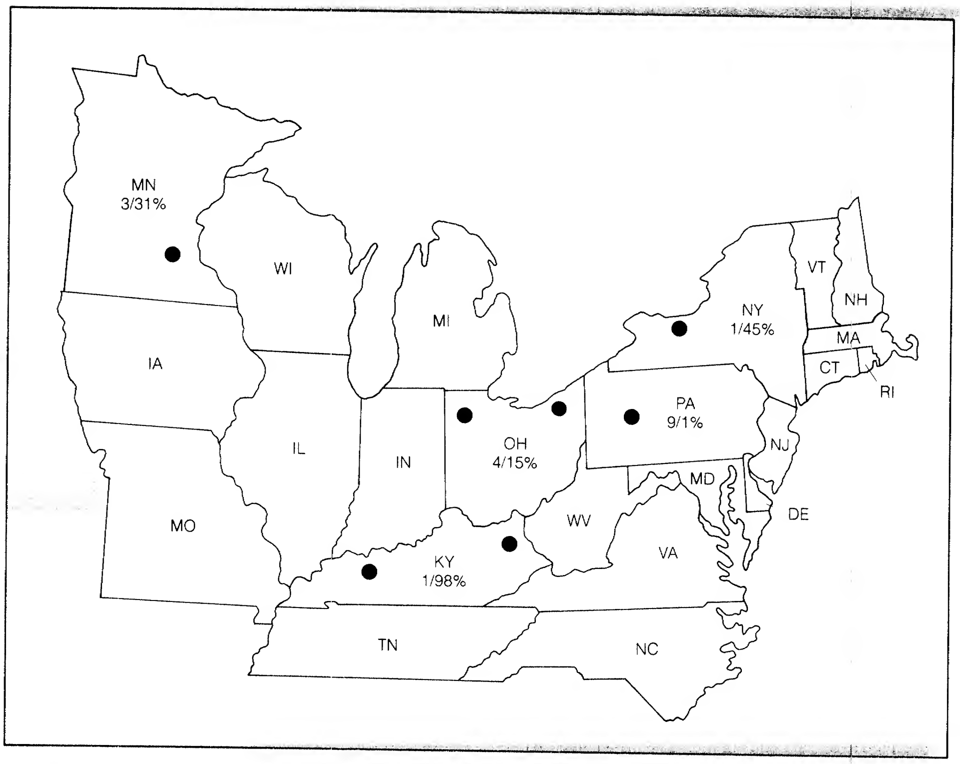
exhibit 5
Domestic refining capacity and utilization, 1978

Capacity rank	*Company*	*Capacity (000 barrels per day)*	*Runs*	*Runs/capacity*
1	Exxon	1,574.0	1,426.0	90.6%
2	Standard of California	1,449.5	1,122.0	77.4
3	Standard (Indiana)	1,238.0	1,114.0	90.0
4	Shell	1,123.4	1,040.0	92.6
5	Texaco	1,059.0	997.0	94.1
6	Gulf	948.7	844.8	89.0
7	Mobil	901.0	788.0	87.5
8	Atlantic Richfield	847.0	815.0	96.2
9	Sun	569.0	551.9	97.0
10	Marathon	533.0	498.9	93.6
11	Union	490.0	430.5	87.9
12	Standard (Ohio)	452.0	423.7	93.7
13	Ashland	364.9	352.9	96.7
14	Continental	363.0	343.5	94.6
15	Phillips	302.0	440.4*	145.8
16	Cities Service	291.0	175.1	60.2
17	Coastal States	266.3	222.0	83.4
18	Champlin	240.3	228.3	95.0
19	Getty	220.6	235.4	106.7
20	Tosco	213.0	150.0	70.4

*Includes natural gas liquids.
Source: *Market Shares and Individual Company Data for U.S. Energy Markets: 1950–1978*, American Petroleum Institute, 1979.

[2] "Crude Poor Ashland Oil: Prototype of the Future," *Business Week*, January 31, 1977, p. 98.

exhibit 6
Ashland's 1979 refining capacity



Note: 3/15% = Rank in capacity among all companies with refineries in the state/Percent of total state capacity operated by Ashland.
• = Refinery locations.
Source: *Oil & Gas Journal,* March 24, 1980.

major oil companies 50 cents a barrel in refining and beat them at the end of the day."[3]

8 Ashland, in fact, had traditionally kept its refining capacity short of its total needs. To fill the gap, it bought products from other refineries for resale. Though such sales were not very profitable, Ashland rarely ever had to cut its refinery runs. For example, in 1976 Ashland sold about 100,000 barrels per day that it did not refine. As a result, it was able to keep its refineries operating at nearly 89 percent of capacity.

9 **Marketing of petroleum products.** Ashland's principal marketing area for gasoline and fuel oils included the Ohio River Valley and the upper Midwest, the East Coast, and a portion of the southeastern United States. The company marketed its petroleum products directly through 150 bulk plants and

[3] Ibid.

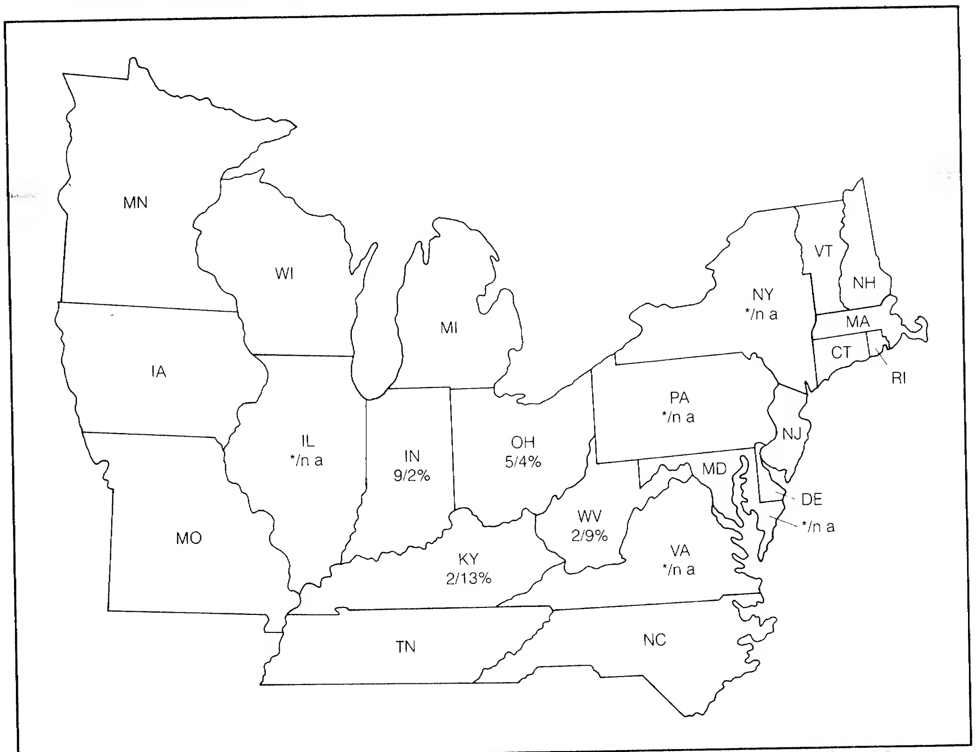
also under various brand names through approximately 2,400 retail outlets (see Exhibit 7 for gasoline marketing area information).

10 Ashland was one of the principal marketers of residual and distillate fuel oil to commercial, utility, and industrial consumers in the Midwest and on the East Coast. Competition in these markets was provided by refiners and broker/resellers and was influenced by a combination of price and reliability of supply and service.

11 Products under Ashland's Valvoline brand name included motor oil, other automotive and industrial lubricants, automotive chemicals, and oil, air, and fuel filters. Valvoline products were sold throughout the United States through an estimated 60,000 dealers and jobbers. They were also marketed elsewhere throughout the world.

12 Ashland had the image of possessing a very efficient distribution system. Its heart was seen as being the network of independent jobbers and retailers. "We have never tried very hard to develop a brand program like the majors

exhibit 7
Ashland's 1979 gasoline sales



Note: 5/15% = Rank in sales among all companies in state/Percent of total state sales by Ashland.
Note: If state is blank, Ashland does not sell gasoline in that state.
* = Below 10th in rank.
n.a. = Percent not available.
Source: *National Petroleum News,* Mid-June 1979.

did," said Charles Luellen, group marketing vice president. "That is a very expensive way to sell gasoline so we concentrated on sales to independent jobbers."[4] In the opinion of an industry refinery-marketing analyst, it cost a major oil company about 15 cents to sell a gallon of gasoline in 1977 versus 3 cents for an independent retailer.[5]

13 **Transportation.** Ashland used a total of approximately 6,200 miles of crude oil and refined products pipelines at the end of fiscal 1979. These pipeline facilities consisted of approximately 3,100 miles of wholly owned pipelines, 1,100 miles of additional facilities in which Ashland held varying percentage interests, and 2,000 miles of crude oil gathering lines, truck pipelines, and accompanying facilities which Ashland operated under long-term leases with options to purchase.

14 The company had access to 43 product terminals during the year. These facilities consisted of 20 river terminals, 19 pipeline terminals, and four lake terminals accessible by ocean-going vessels.

15 Ashland's river transportation facilities, including towboats, barges, and terminals provided low-cost transportation for both crude oil and refined products on the Ohio and Mississippi Rivers and their tributaries. The company owned or leased 22 towboats and 218 barges.

16 The company's fleet also included a 259,234 deadweight ton VLCC (very large crude carrier), which the company owned. In addition, six vessels totaling 998,021 deadweight tons were under long-term charters. Remaining crude transportation requirements were filled by securing tankers on a spot basis for individual voyages.

17 Ashland Petroleum leased 932 railroad cars at the end of fiscal 1979. The company also owned an extensive number of tractor-trailer units, additional trailers, and a large fleet of tank trucks and general service trucks.

18 **Chemicals.** Ashland's chemical operations were conducted by the Ashland Chemical Company division. It was primarily engaged in the manufacture, distribution, and sale of numerous chemical products. The division had manufacturing and distribution facilities in 28 states and 14 foreign nations. Revenues of the chemical company for fiscal 1979 were 15.1 percent of total Ashland revenues. Net income was 19.3 percent of the total net income of Ashland.

19 In 1974, Atkins said that, "the government is going to keep price ceilings on consumer-oriented fuel such as gasoline and home heating oil. You will probably be able to get more money by going into higher margined petrochemicals."[6]

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[4] Ibid.
[5] Ibid.
[6] "Chemical Change," *Forbes,* November 15, 1974, p. 68.

20 Consistent with this philosophy, Ashland put substantial amounts of capital into chemicals. In fact, during fiscal 1979, the chemical division was the second largest recipient of Ashland's capital expenditures (see Exhibit 8 for capital expenditures.)

exhibit 8
Ashland Oil's capital expenditures: 1969–1979 ($ millions)

Year	*Total*	*Petroleum refining*	*Exploration and production*	*Chemical*	*Coal*	*Construction*	*Canada*	*Other*
1980*	$300	$170	$30	$30	$35	$25	—	$10
1979	292	142	26	24	31	29	—	40
1978	317	131	59	18	25	34	$42	8
1977	501	149	155	25	78	39	50	5
1976	256	105	53	26	—	34	32	6
1975	240	72	87	29	6	38	34	14
1974	188	37	51	12	—	34	29	25
1973	175	33	70	14	—	—	29	29
1972	124	35	24	23	—	—	15	27
1971	86	28	15	7	—	—	13	23
1970	82	28	18	14	—	—	9	13
1969	115	34	33	16	—	—	9	23

*Estimated.
Source: Ashland Oil, Inc. annual reports, 1979, 1978, and 1973; and *The Wall Street Journal*, February 1, 1980.

21 However, Ashland's record in the chemical business was a bit spotty. After the big expansion and acquisition program in the early 1960s, chemical profits sagged for a five-year period, despite an increase in sales. In 1974, however, Atkins was confident that the overcapacity that hit the chemical industry would not recur. "The cost of new capacity is so high that the industry won't have the propensity to create the gluts that it had in past years."[7]

22 Ashland's chemical plants were constructed on existing refinery properties. This provided guaranteed access to refinery-produced feedstocks for chemical production.

23 **Coal.** Ashland was the sixth largest coal producer in the United States in 1979. Net income from coal operations in that year was 3.3 percent of the total net income of the company. According to Yancey, "We see coal as a tremendous growth area for us in the 1980s."[8]

24 Ashland's coal operations were conducted primarily by two separate companies: Arch Mineral Corporation (Arch) and Ashland Coal, Inc. Arch was 50 percent owned by Ashland and had been formed in 1969. It was primarily engaged in seeking out, acquiring, and developing coal reserves intended to supply the electric utility market. During fiscal 1979, Arch sold a

[7] Ibid.
[8] "Crude Poor Ashland Oil."

total of 12.9 million tons of coal from six operating surface mines located in Alabama, Illinois, and Wyoming. The sale of coal from each mine had been arranged primarily under contracts with utility companies. A large portion of these sales were under long-term contracts with market reopener clauses and/or provisions for the pass-through of various elements of cost, including reclamation costs. The balance of the sales were represented by short-term contracts at prevailing spot prices.

25 Ashland Coal, a wholly owned subsidiary, was engaged in the production, transportation, processing, and marketing of bituminous coal. Production was primarily from surface mines in eastern Kentucky and West Virginia. Since its inception in 1975, the primary emphasis and direction of Ashland Coal had been placed on the acquisition and development of steam coal reserves.

26 **Construction.** Ashland's construction operations were conducted by Ashland-Warren, Inc., an indirect, but wholly owned subsidiary. The company was engaged principally in the production and sale of construction materials and the performance of contract construction work. Materials produced and sold included asphalt and ready-mixed concrete, crushed stone and other aggregate concrete blocks, and certain specialized construction materials. Areas of contract construction included the paving of highways; urban streets; roadways; bus lanes; airport, shopping center, and other commercial parking areas; and sidewalks and driveways with asphalt and portland cement concrete surfacing.

27 During 1979, Ashland-Warren sold the assets of its northeast regional operations. As a result, Ashland-Warren's operations were concentrated in the southern and southwestern United States.

28 **Shipbuilding.** Levingston Shipbuilding Company, an indirect, wholly owned subsidiary of Ashland, operated fabrication yards in Texas. Levingston manufactured various types of marine equipment including semisubmersible and jack-up drilling platforms for the petroleum industry, drilling ships, pipe laying, derrick and tanker barges, and other vessels. It also performed major marine repair projects. It had eight dry docks, a marine railway, and two large machine shops. In the fall of 1978, the Federal Maritime Administration contracted with Levingston to build up to five 36,000 deadweight ton dry-bulk cargo ships, with scheduled delivery dates from December 1980 to December 1982.

29 **Exploration.** Ashland's exploration activities were conducted by Ashland Exploration, Inc., an indirect, wholly owned subsidiary. As of 1979, the company was engaged in the exploration for, and production of, oil and gas in the eastern part of the United States and, through various subsidiaries, in Nigeria and Sharjah.

30 At the beginning of fiscal 1979, Ashland owned interests in producing oil

and gas leases in 18 states and in the Gulf of Mexico. Between them, these lease properties contained 9,034 (3,990 net) producing wells. Production averaged 12,600 net barrels per day of oil and natural gas liquids and 153 million net cubic feet per day of natural gas. At year-end, after the sale of much of its properties, Ashland owned 2,783 (2,398 net) producing wells.

31 The major retained interests consisted of producing and nonproducing properties located in the central and eastern regions of the United States, primarily in the states of Illinois, Indiana, Kentucky, Ohio, Virginia, and West Virginia. The average price received during fiscal 1979 by all oil companies for a barrel of oil was $11.37. The average price received by Ashland for a barrel of oil from these remaining properties, however, was $18.93. The difference in price was due to the fact that 97 percent of Ashland's production in the remaining properties was of the stripper category and was thus not subject to governmental price controls.

Ashland within the industry

32 Within the U.S. oil industry, Ashland maintained a steady relative position throughout the 1970s. The following data indicates Ashland's rank among all U.S. oil companies in four categories:[9]

	Rank			
	1978	*1976*	*1974*	*1972*
Operating revenues	13	13	14	14
Net income	16	18	19	16
Gasoline sales	15	16	15	15
Total assets	17	18	17	18

Exploration activities

33 In the late 1960s, Ashland decided to diversify into crude oil exploration and production. While Orin Atkins believed that the marketing of refined products should continue to be Ashland's primary line of business, he was apparently concerned about the "opportunity loss" of not being an active participant in the exploration and production phase of the business.

34 In August of 1969 Atkins discussed his strategy: "We're one of the few oil outfits that pays a real tax bill. By drilling, (we'll) get the 27.5 percent oil depletion allowance and what the oil companies call the intangible drilling costs for tax purposes. When you drill a well, you get immediate savings in tax of about 60 percent of the costs. . . . We have developed a strong enough base to afford some of the risks of exploring for oil. . . . This is a real first-class crap game."[10]

[9] *National Petroleum News, Facts Book,* 1979, 1977, 1976, 1974.
[10] "A First Class Crap Game," *Forbes,* August 1, 1969, p. 41.

35 Ashland's initial exploration activities required an investment of $43 million in the 1966–69 period. The massive investment reduced the firm's earnings per share from $2.48 in 1966 to $2.19 in 1969. The outcome of one of the exploratory efforts was the drilling of eight dry holes in the Santa Barbara channel, and the taking of an $8 million write-off in 1969 related to those efforts.

36 Again in 1971 Ashland was forced to take large write-offs related to exploration in Alaska, after drilling a series of dry holes. In 1972, the company purchased from Union Carbide Corporation that firm's oil and gas properties, and extended its exploration activities even further. However, the exploration arm of Ashland lost money in 1973.

37 Success continued to elude Ashland in its exploration activities as the 1970s wore on. In 1973 through 1975 it drilled a number of dry holes in Iran and abandoned its concession there in 1975. In 1976 it also abandoned its efforts in the Java Sea, after taking a significant write-off related to those activities. Although the company did drill some successful wells during the 70s by 1977 it had developed only enough producing wells to supply 20 percent of the crude needed by its refineries. See Exhibit 9 for Ashland's production and reserve figures for 1969–1979.

exhibit 9

Ashland reserve and production data

			Proved reserves	
Year	*Oil production (barrels per day)*	*Gas production (million cubic feet per day)*	*Oil (million barrels)*	*Gas (billion cubic feet)*
1979	28,372	176,371	15	173
1978	59,585	233,000	99	1,114
1977	59,335	215,000	101	1,082
1976	64,201	230,000	82	1,098
1975	62,498	254,000	82	1,155
1974	55,341	272,449	n.a.	n.a.
1973	50,987	312,201	167	1,362
1972	41,696	171,669	170	1,389
1971	41,192	153,772	147	1,312
1970	31,950	109,357	108	1,189
1969	32,471	105,015	104	1,178

n.a. = Not available.
Source: *Ashland Financial and Operating Supplements*, 1969–1979 editions.

38 One of the reasons was the increasing cost of finding oil. According to the American Petroleum Institute, the cost of drilling an average well rose 38 percent from 1974 to 1976. Later in the 1970s, as more attention was given to offshore properties, such as the Baltimore Canyon, the average price of drilling a well increased even more, as a single offshore well in such an area could cost up to $10 million. Ashland's finding costs (the financial outlay needed to find and develop reserves) was $3.75 per barrel, averaged over the 1974 to 1978 period, which was higher than the industry average over the same period of $3.09 per barrel.

39 There were other factors affecting the profitability of the exploration and production activities of other companies. After the 1973 oil embargo, many foreign governments, particularly in the Middle East, became increasingly hard-nosed about allowing American and European companies to make huge profits on the oil produced in their countries. Their method of preventing such large profits was to raise their interest in the wells operated by other companies or nationalize those properties entirely. Both of these tactics were used increasingly throughout the 70s, so that the profitability of overseas production for many companies declined. In addition, currency devaluations in 1976 severely crimped earnings from foreign operations for many companies.

40 Throughout the 1970s, as its exploration and production fortunes were rising and falling, Ashland's refining and marketing operations increased significantly. From 1972 to 1977, revenues from those activities increased from $1.3 to $2.8 billion. At the same time earnings increased in all but one of those years, making Ashland one of the few U.S. companies to earn money consistently through the 1970s on refining and marketing. Throughout the period, Ashland's refineries ran at high capacity, reaching 89 percent of capacity in 1976.

41 In 1978, Atkins reflected on the state of Ashland's exploration and production operations: "It's become the kind of game we can't play. We've spent almost $900 million in the last five or six years . . . my nose is just above water at that level."[11]

42 Atkins went on to say that the high cost of offshore properties, changed tax policies at home, and more aggressive governments abroad had eroded the profitability in exploration and production for all but the largest or luckiest oil companies. He publicly blasted Washington for creating "a hostile environment toward exploration."[12] Yet, he clearly felt that the federal government would serve an important role as a sort of insurer of last resort for Ashland if crude oil shortages were to develop.

43 Ashland's refineries were located on strategic sites near or alongside significant industrial complexes in Kentucky, Ohio, New York, and Minnesota. Atkins observed that, "if our refineries don't have crude oil, no industry runs in those areas and no commercial enterprises operate."[13] He simply did not believe that the federal government would allow such a situation to develop.

The divestment decision

44 As noted earlier, Ashland decided in 1978 to divest itself of much of its oil and gas producing properties. Later the same year when this strategy was

[11] "Ashland Oil: Getting Out of Crude."
[12] Ibid.
[13] Ibid.

publicly announced, Atkins explained his phaseout of oil production by saying, "Right now you have a surplus of oil and we see that situation continuing two or three years at least."[14]

45 Atkins was the first to admit that the divestment decision was not an easy one. "I stayed awake most nights for three months thinking about this."[15] He felt the sell-off would fit in with Ashland's larger strategy of selling off businesses with low profitability and lackluster growth prospects. The total planned divestment would trim almost $1.5 billion from the $5.1 billion in revenues that Ashland had reported during fiscal 1978. The plans Atkins had for the proceeds of this unprecedented move were rather unconventional. Some of the money was to go toward retiring Ashland's debt, repurchasing shares of common stock, and making new investments. A good part of the money, however, was targeted for the shareholders in the form of higher or even special dividends. Said Atkins, "Unfortunately, the great majority of corporations in America are run for the employees but we're going to run this one for the shareholders."[16]

46 The divestment decision, and the logic used by Atkins to support that decision, did not generate total support within the firm. The president of Ashland Exploration, Inc., for example, was quoted as having said: "I can't understand it myself. Production and exploration operations are the best part of an oil company."[17]

47 Others charged Ashland with having had an erratic and irregular commitment towards finding oil. Senior Vice President Burt E. Hamric, for example, disclosed that: "Our [exploration and production] budget would fluctuate wildly from year to year, or within a year."[18]

Implementing the divestment decision

48 In October of 1978, Ashland sold its 79 percent interest in Ashland Oil Canada Limited. This was an oil and gas exploration and production company in Canada. The sale garnered approximately $316 million in before-tax gross cash proceeds.

49 In December of 1978, Ashland sold its coating resins business and its related facilities in Newark, New Jersey; Valley Park, Missouri; and Pensacola, Florida. These sales brought in approximately $20 million in cash. In January of 1979, it sold the Chemical Products Division of Ashland Chemical for approximately $60 million in cash.

50 In April of 1979, Ashland sold most of the northeast region of the Ashland-Warren construction division for approximately $42 million in cash.

[14] Ibid.
[15] Ibid.
[16] Ibid.
[17] Ibid.
[18] "Ashland Oil: Scrambling for Crude after Premature Sell-off," *Business Week*, February 4, 1980, p. 111.

Ashland decided that for the then-present time it would discontinue efforts to divest any other parts of the Ashland-Warren operations, with the possible exception of Levingston Shipbuilding Company and certain road construction operations in the western United States.

51 In March and April of 1979, Ashland made the following sales of various oil and gas properties:

Oil and gas producing properties in the Rocky Mountains, southeast, and southwest regions for approximately $117 million in cash.

Oil and gas leasehold estates and other property interests in the Rocky Mountain, southeast, and southwest regions for $17 million in cash.

Mid-continent region oil and gas properties for approximately $331 million in cash.

Oil and gas properties located offshore Louisiana and Texas and support facilities for approximately $266 million in cash.

All stock interest in Ashland Oil (GB) Limited, which held an interest in the United Kingdom North Sea production properties known as the Thistle Field, for a total consideration of $94.5 million.

52 The March–April 1979 sale of these oil and gas properties and operations, adjusted for other miscellaneous sales, resulted in the receipt by Ashland of before-tax net cash proceeds of approximately $826 million. In connection with the sales it was estimated that U.S. federal income taxes of $256 million would be payable by Ashland in fiscal 1980.

53 Two other significant events occurred during late 1979 as Ashland's management moved toward full implementation of the divestment decision. First, bids in excess of $100 million were made for Ashland's remaining domestic oil and gas properties. These properties were located in the central and eastern portions of the United States. The bids were rejected.

54 The second event involved the sale of the Brae Field interests. This occurred on November 13, 1979, and involved Ashland's interest in an oil and gas producing property known as the Brae Field in the United Kingdom sector of the North Sea. The sale resulted in the receipt of approximately $3.7 million in cash, and the purchaser's assumption of approximately $16.9 million in indebtedness.

Use of the divestment monies

55 Industry observers believed that the proceeds of the various sales of properties would provide at least $700 million for Ashland to invest elsewhere. Atkins, however, stated that the available money was of a lesser amount. The sharp increase in crude oil prices had resulted in larger investments in inventory. Changes in the terms for buying foreign crude oil—with payment required within 30 days rather than within 60 days—was said to have absorbed more than $200 million of Ashland's cash. Further, Atkins said that

Ashland also had taxes to pay, probably referring to the \$256 million which would be due in fiscal 1980.

56 Ashland was said to be interested in making acquisitions. However, Atkins observed that: "We feel that at the present juncture of the economy, there are more pitfalls in acquisition areas than opportunities."[19]

57 Ashland's management did make some other uses of the funds, however. Basically, they were used to: (1) retire debt, (2) repurchase shares, and (3) pay additional cash dividends to the remaining shareholders. More specifically, the following events took place:

1. In November of 1978, the 10 percent sinking fund debentures due in the year 2000 were redeemed at a redemption price of \$110.6 million.
2. Throughout 1978 and 1979, the firm purchased a total of 15.6 million shares of its common stock for approximately \$565 million. (The 15.6 million number is after giving effect to the November 1978 three-for-two stock split.)
3. In November 1978, the quarterly cash dividend on the common stock was increased from 50 cents per share to 60 cents per share on a presplit basis (to 40 cents on a postsplit basis).
4. In March 1979, the board of directors further increased the dividend rate to 50 cents per (postsplit) share.
5. In December 1979, the dividend was further increased to 55 cents per share.

Crude oil: Supply, price, and government involvement

58 Due to the influence of OPEC and the Arab oil embargo of 1973–74, both the price and supply of crude oil were substantially altered. All firms involved in the refining business were affected. To what extent, however, depended upon such factors as location of the refineries, amount of proved reserves, and terms of contractual obligations.

59 In August of 1973, the federal government, through the Federal Energy Administration (FEA) installed price controls in order to keep U.S. producers from realizing windfall profits as a result of OPEC raising the world market price. Production at 1973 levels was classified as old oil. Its price was frozen at \$5.25 per barrel. The price of new, stripper, or imported oil was allowed to float with the market, up to a ceiling of \$14 per barrel.

60 Price controls substantially affected the independent refiners. Integrated majors began cancelling the contracts they had with independent refining firms because each barrel they sold at \$5.25 had to be replaced by uncontrolled oil. Therefore, the independents had to rely heavily on new or imported oil in order to keep their refineries running.

[19] "Ashland Oil Believes It Was Right in Sale of Most Exploration, Production Interests," *The Wall Street Journal*, February 1, 1980.

61 In addition, retail prices were controlled by formulas based on each refiner's average cost of crude oil and refining. The majors not only had lower cost crude going into their refineries, but as a result, they were forced to reduce their retail prices and, hence, increase their market share.

62 In early 1974, the FEA chose to once again intervene in the marketplace. At this time the administration's intention was to place all domestic refiners on an equal footing to weather the economic storm caused by the Arab oil embargo. The allocation program, which went into effect February 1, 1974 attempted to distribute all available oil to maintain existing refiners' operations at equal capacity utilization ratios.

63 The FEA estimated the national average crude oil supply/capacity ratio to be 77 percent. Refiners with ratios below 77 percent were allowed to buy oil from refiners with ratios above 77 percent. The FEA determined the amount of oil a company must buy or sell, but the refiners arranged contracts on their own. The sale price was determined by the seller's average cost of crude. The program succeeded in equalizing capacity utilization. However, since not all sellers had the same average cost of crude, industry crude costs and product prices still varied greatly.

64 **The entitlements program.** The entitlements program went into effect in November 1974. This new program attempted to solve the price squeeze the independents were facing by equalizing crude acquisition costs. The refiners who ran more than the industry average of old oil were required to compensate those who ran less. The amount of these payments, or "entitlements" was determined by the difference between the cost of old oil ($5.25) and the average cost of new, stripper, and foreign oil.

65 During 1976 Ashland paid an average of $12.46 per barrel for its crude, but because it was able to sell entitlements, its average cost was reduced to $11.52 per barrel. Ashland sold $132 million worth of entitlements during the first 14 months of the program. Amerada Hess, the biggest benefactor from the program, sold $299 million worth during the same time period. According to one industry source, "I have a lot of respect for Ashland's efficiency but they wouldn't be in business without entitlements."[20]

The Iranian oil cutoff

66 Iran was supplying 100,000 barrels per day to Ashland when the next major disruption of supply occurred, on November 12, 1979. The Department of Energy's Office of Hearings and Appeals (OHA) ordered nine oil companies to supply Ashland with 80,000 barrels per day until February of 1980 to partially make up for the loss of oil from Iran. They responded to this order with a suit that sought to overturn it and harshly attacked Ashland's planning. They contended that not only did they face tight supply situations

[20] "Crude Poor Ashland Oil."

themselves but that Ashland had just recently sold off its oil and gas producing capabilities, indicating at the time that other companies would have to help it if things got tough. In addition, Marathon Oil challenged the constitutionality of the OHA action.

67 The outcome of the legal action was expected to go Ashland's way because federal policy had generally been drifting toward a government-controlled system of allocation of crude, regardless of its source. Beyond that, Ashland, despite its medium size, operated one of the most powerful lobbies in Washington. Because it had always been dependent on other producers for its crude oil, Ashland had been particularly vulnerable to political actions that might interfere with its supply.[21]

Crude oil supply and the divestment

68 At the time its oil and gas properties were sold, Ashland claimed that the sale would not have a material effect on its supply of crude oil since its properties had provided less than 10 percent of the crude oil refined by its refineries. Negotiated lease and contract purchases of U.S. crude oil accounted for approximately 95,000 barrels per day. During fiscal 1980, Ashland anticipated Canadian imports to be in the range of 10,000 to 15,000 barrels per day. The balance of Ashland's requirement of 295,000 barrels per day was expected to come from two sources. First, much of it would result from contracts with members of OPEC (Organization of Petroleum Exporting Countries), including Saudi Arabia, Abu Dhabi, and Algeria. Second, the firm planned to make use of spot purchases from the North Sea, Mexico, and other miscellaneous sources.

69 During fiscal 1978, approximately 22 percent of Ashland's crude oil requirements had been satisfied by direct and indirect purchases from Iran. This percentage declined to about 16 percent in fiscal 1979, largely as a result of the change in the Iranian government and the cessation of purchases from Iran at the end of November 1979. On November 12, 1979, President Carter suspended imports of Iranian oil due to events in Iran involving American citizens.

70 During fiscal 1978 and 1979, approximately 52,000 barrels per day or 14 percent of Ashland's crude requirements were satisfied directly or indirectly by purchases for Abu Dhabi. That country advised Ashland in late 1979 that its crude shipments in 1980 would be reduced to 20,000 barrels per day.

[21] The lobby did cause Ashland some trouble, however. During 1973 and 1974, the company was twice convicted of violating the Federal Election Campaign Act of 1971 by making illegal political contributions in the United States. As a result, Ashland signed a consent decree promising not to make illegal political donations in the future.

Ashland was also charged with concealing payoffs to foreign officials in connection with its oil exploration and production. In response, the Securities and Exchange Commission insisted that Ashland publicly reveal the recipients of all its illegal payments. Ashland reluctantly complied.

71 Ashland was unable to predict the effect these actions would have on its crude oil requirements or the price that it would have to pay to obtain crude. However, Ashland's management did believe that a government allocation program might well be needed to give it access to other sources of crude. Barring such a move, these actions by suppliers could have had a material adverse effect upon its ability to operate its refineries at near capacity.

72 Ashland estimated that its crude oil requirements for its refineries would average approximately 412,000 barrels per day for fiscal 1980. Most of this would be derived from negotiated lease and contract purchases. Less than 11,000 barrels per day of Ashland's crude oil requirements was expected to be satisfied in fiscal 1980 from production owned by Ashland.[22] Of this amount, 2,300 barrels were to be produced in the United States, 6,400 barrels in Nigeria, and 2,200 in Sharjah.

The impact and the return

73 The doubling of oil prices in 1979 increased the reported profits of most oil companies to politically embarrassing levels. This trend, however, was not evenly distributed throughout the industry. Ashland Oil, for example, reported a year-to-year increase of 16 percent. This contrasted sharply with firms such as Mobil, which reported an increase of 70 percent.

74 When Ashland decided to sell its oil and gas properties, among the first to buy was Lear Petroleum Corporation. In March of 1979, they paid \$17.8 million to obtain exploratory leases on 1.1 million acres in 19 states. Two months later, with its first exploratory well on these properties, it found natural gas south of Tyler, Texas. This discovery was large enough to guarantee a substantial drilling program. When Lear bought from Ashland, they also hired David L. Paffett who had been Ashland's exploration manager. A delighted Paffett, now Lear's vice president of exploration, gleefully explained, "The first well has paid for the entire bid, and that ain't just plowing smoke."[23]

75 However, there were no loud complaints from Ashland's stockholders. The sale of its domestic and Canadian oil and gas properties—including 41 million barrels of proven oil reserves, 906.7 billion cubic feet of gas, and 5.4 million acres of leases—netted Ashland over \$1 billion. As noted earlier, Ashland returned some of the proceeds to stockholders in the form of higher cash dividends. The price of its common stock moved up quite significantly over roughly the same time frame. Between June 1978 and April 1979, the market price per share rose by 50 percent. (See Exhibit 10.)

76 Industry experts, however, were not so complimentary in their view of the firm's divestment actions. Many of them suspected that Ashland could have netted substantially more from the sale of its exploratory acreage if it

[22] Ashland's fiscal year ended on September 30.
[23] "Ashland Oil: Scrambling."

exhibit 10
Common stock statistics

	Price range				
Year	*High*	*Low*	*Annual dividend*	*Earnings**	*Book value*
1979†	45½	27	$1.80	$15.55	$29.33
1978	34	18	1.33	5.51	22.76
1977	24⅞	19⅜	1.27	3.73	27.75
1976	23	12⅞	1.10	3.35	24.88
1975	16½	11	.98	2.94	21.46
1974	18¼	10¼	.92	2.96	19.56
1973	22½	14	.82	2.24	16.16
1972	23⅜	15⅝	.80	1.76	14.15
1971	20⅜	12⅝	.80	.98	13.06
1970	18⅞	11⅜	.80	1.39	13.25
1969‡	36⅝	15	.80	1.53	13.79

All earnings per share data assumes no conversion and is stated after consideration for special items.

†There was a 3-for-2 stock split in 1979. By November 1979, the annual dividend had been increased to $2.20.

‡Restated for comparative purposes on a pooling of interest basis.

Source: *Moody's Industrial Manual*, 1978 and 1972; and Ashland Oil, Inc., annual report, 1979.

had simply waited another year. "Most clearly, because Ashland failed to anticipate that crude prices would rise, it badly underestimated the worth of its now divested assets."[24]

77 Orin Atkins, however, was not contrite. Based on the technical data available to him at the time of the sales, he later calculated that the changed economics of 1980 might have resulted in a 10 percent increase in the sales prices. While admitting that oil prices had risen, he noted that Ashland's original projections had included the assumption that the windfall profits tax would eventually be based on a 50 percent tax rate. By early 1980, he noted, it looked like the tax rate was going to be 70 percent. When the tax was signed into law in April of 1980, the total tax on the estimated $1 trillion windfall resulting from price decontrol was expected to be $779 billion ($227 billion taxed by the federal windfall and $552 billion taxed by state and local governments).[25]

Recent events

78 In late 1979 Ashland quietly began what appeared to be a reversal of its crude divestment strategy. Without the fanfare that accompanied the sell-off, Ashland financed an exploratory venture by Patrick Petroleum Company off the Texas coast. Ashland expected to spend up to $25 million for the privilege of having the first option to buy what Patrick might find. In January

[24] Ibid.

[25] *The Wall Street Journal*, April 1, 1980.

of 1980, Ashland tentatively agreed to search jointly for oil with Basic Resources International of Luxembourg. This exploration program was to be in Guatemala. It was expected to cost Ashland between \$10 million and \$20 million per year.

79 At the same time Ashland continued to seek higher returns from its expertise in refinery processes. In early 1980, the company planned to build a pilot plant for proving the feasibility of producing a petroleum-like fuel from coal. If successful over a four- to five-year period, the small plant might lead to a commercial size installation, estimated to cost about \$1.5 billion, excluding another \$500 million for coal facilities. Ashland officials expected such a large plant would be built in cooperation with several other oil companies so that the financing requirement could be split up.

80 In April of 1980, the company announced its discovery of a new, more efficient refinery process which could improve the yield of gasoline from residual fuel. As Orin Atkins described it, "The process increases the yields of gasoline in excess of 70 percent" and reduces crude oil consumption 20 percent.[26] In addition to utilizing the new technology to increase its own refinery efficiency, Ashland hoped to license the technology to other major oil companies in exchange for long-term supplies of crude oil.

81 Ashland was also planning to spend some of its divestments-related cash proceeds to prepare its refineries to operate with the higher proportion of heavy crudes available in the international markets. Crude-starved Ashland felt that this would be to their advantage in future years.

82 To further alleviate this tightness in crude supplies, Ashland searched internationally for new sources. The firm was successful in increasing the size of its oil supply contract with Saudi Arabia to 28,000 barrels a day, from 23,000 barrels a day. In so doing, it became the only U.S. company to deal directly with the Saudi oil company Petromin. Ashland also concluded a deal with the Saudis to build a \$200 million lubricating oil refinery in their country, in exchange for future increases in oil shipments to Ashland. It was hoped the increase would be up to 40,000 barrels a day above current contracts.

83 Ashland also depended on terms of the agreements under which it has sold its oil reserves and producing properties for crude oil. Those agreements in most cases gave Ashland the right to purchase crude oil from the new owners of the properties, but most of these oil rights agreements were due to expire in two to three years after the purchase. It was therefore questionable in the spring of 1980 whether Ashland could maintain the pace of refinery runs (about 85 percent of capacity) that it considered desirable for profitable operation.

[26] *The Wall Street Journal*, April 1, 1980.

case 13

Anheuser-Busch Companies, Inc.

Background of the firm

1 In 1852, Georg Schneider opened the Bavarian Brewery on the south side of St. Louis, Missouri. Five years later, the brewery faced insolvency. In 1857, it was sold to competitors who renamed it Hammer and Urban. The new owners launched an expansion program with the help of a loan from Eberhard Anheuser, a successful soap manufacturer at the time. By 1860, the brewery had faltered once again and Anheuser assumed control. Four years later, his son-in-law, Adolphus Busch, joined the brewery as a salesman. Later Adolphus became a partner and finally president of the company. Busch was the driving force behind the company's success, and in 1879, the company name was changed to Anheuser-Busch Brewing Association.

2 An important reason for the brewery's success was Adolphus Busch's innovative attempt to establish and maintain a national beer market. In 1877, he launched the industry's first fleet of refrigerated freight cars. He also pioneered the application of a new pasteurization process. Busch's talents were not limqted to technology alone; he concurrently developed merchandising techniques to compliment his technological innovations. By 1901, annual sales had surpassed the million-barrel mark for the first time.

3 August A. Busch succeeded his father as president of Anheuser-Busch in 1913. With the advent of Prohibition, he was forced to harness the company's expertise and energies into new directions (i.e., corn products, bakers' yeast, ice cream, commercial refrigeration units, truck bodies, and nonalcoholic beverages). These efforts kept the company from collapsing during the dry era. With the passage of the 21st amendment, Anheuser-Busch was back in the beer business. To celebrate, a team of Clydesdale horses was acquired in 1933—the Budweiser Clydesdales.

4 In 1946, August A. Busch, Jr., became president and chief executive officer. During his tenure, the company's beer operation flourished. Eight breweries were constructed and annual sales increased from 3 million barrels in 1946 to more than 34 million in 1974. The corporation also diversified extensively, adding family entertainment centers, real estate, can manufacturing, transportation, and a major league baseball franchise.

5 August A. Busch III was elected president in 1974 and chief executive officer the following year, making him the fifth Busch to serve in that capac-

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ity. Thus far under his direction, Anheuser-Busch has accomplished the following: opened its 10th brewery, introduced Michelob Light, Anheuser-Busch Natural Light, and Würzburger Hofbräu; opened a new Busch Gardens theme park; launched the largest brewery expansion projects in the company's history; vertically integrated into new can manufacturing and malt production facilities; and diversified into container recovery, soft drinks, and snack foods.

The industry and competition

6 Ninety percent of Anheuser-Busch's sales come from their beer products. (Generically, the term *beer* refers to any beverage brewed from a farinaceous grain.) The type of beer consumed in America today originated in the 1840s with the introduction of lager beer. Lager beer is bottom fermented (meaning yeast settles to the bottom during fermentation). The beer is then aged (or lagered) to mellow, resulting in a lighter, more effervescent potation. Prior to 1840, Americans' tastes closely resembled British tastes (i.e., heavily oriented toward ale, porter, and stout). The influx of German immigrants in the 1840s initially increased the importance of lager beer because of the influence of German tastes and brewing skills.

7 By 1850, there were 430 brewers in the United States producing a total of 750,000 barrels per year, and by the end of the decade, there were 1,269 brewers producing over 1 million barrels per year. At that time, brewers served relatively small local areas. In the latter half of the 19th century, several significant technological advances were adapted to the beer industry including artificial refrigeration, mechanized bottling equipment, and pasteurization. The latter innovation enabled brewers to ship warm beer and store it for a longer period of time without refermentation. With developments in transportation technology, the 20th century saw the rise of the national brewer. The combined impact of these technological advances resulted in greater emphasis on marketing as the primary instrument of competition.

8 The modern era of the brewing industry begins with the end of World War II. Prior to that time, only a few brewers sold beer nationally, and they primarily operated out of a single plant. To offset additional transportation costs not incurred by local or even regional brewers, the national firms advertised their beers as being of premium quality and charged a premium price. This structural change in the industry (from predominantly local or regional to national producers) in the post-World War II time period has resulted in a steady decline in the number of brewers and plants and an increase in the market concentration of the large national brewers. Exhibit 1 shows the number of breweries and brewery firms for 1946–1976. Exhibit 2 shows concentration ratios for 1935–1977.

9 In the period following World War II, annual beer sales hit a record high

exhibit 1
Number of breweries and brewery firms: 1946–1976

Year	*Plants*	*Firms*
1946	471	
1947	465	404
1948	466	
1949	440	
1950	407	
1951	386	
1952	357	
1953	329	
1954	310	263
1955	292	
1956	281	
1957	264	
1958	252	211
1959	244	
1960	229	
1961	229	
1962	220	
1963	211	171
1964	190	
1965	179	
1966	170	
1967	154	125
1968	149	
1969	146	
1970	137	
1971	134	
1972	131	108
1973	114	
1974 (June)	108	
1976	94	49

Source: For the years 1946–74: *Brewing Industry Survey* (New York: Research Company of America, 1973, 1974); 1947–72 (for number of firms): U.S. Bureau of the Census, *Census of Manufactures*; and 1976: *Brewers Digest Brewery Directory, 1977*.

exhibit 2
National beer sales concentration ratios: 1935–1977 (percent)

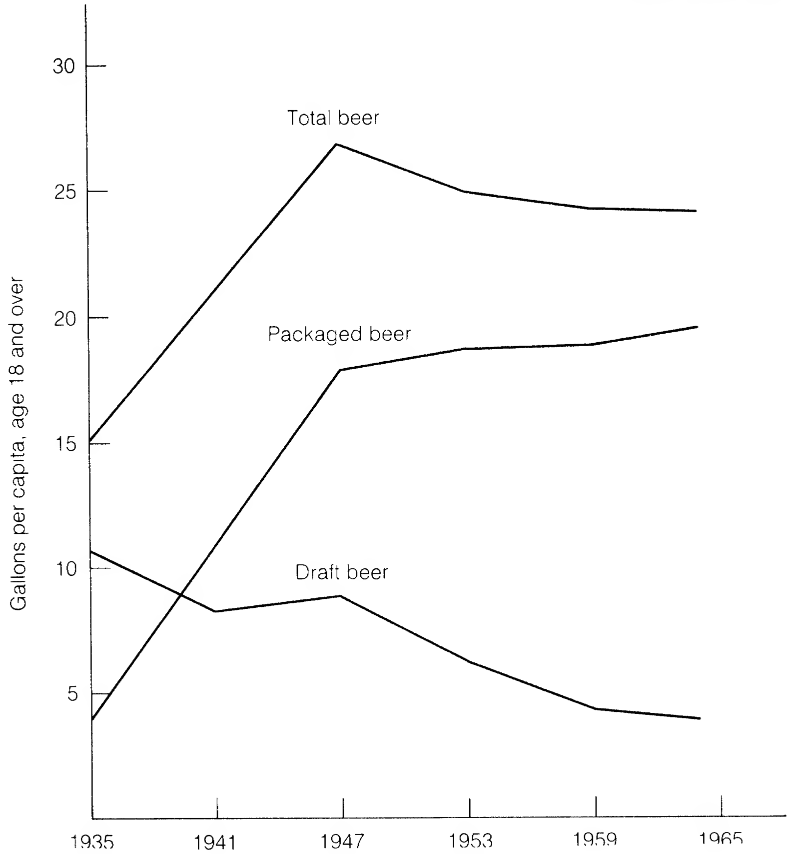
Year	*Four firm*	*Eight firm*
1935	11	17
1947	21	30
1954	27	41
1958	28	44
1963	34	52
1966	39	56
1967	40	59
1970	46	64
1972	52	70
1973	54	70
1974	58	74
1975	59	78
1976	59	80
1977	63	83

Source: For the years 1935–72: U.S. Bureau of the Census, *Census of Manufactures* (based on value of shipments, establishment basis); 1973: based on share of total sales of U.S. brewers in *Brewing Industry Survey (1974)*; 1974–75: based on sales data in *Advertising Age* November 3, 1975, and December 27, 1976; and 1976–77: based on sales data in *Modern Brewery Age*, February 14, 1977, and February 13, 1978, by permission.

in 1947 and then declined and stagnated until 1959. Exhibit 3 shows per capita demand trends in total beer, packaged beer, and draft beer for this time period.

10 Many analysts blamed the lack of growth in demand upon demographic factors. According to *Brewers Almanac 1976* (p. 82), past industry surveys have shown that persons in the 21–44 age group account for about 69 percent of beer consumption. Since this age group exhibited little growth during 1948–1959, population demographics offer a good explanation for stagnated demand during this period. However, other factors must be introduced to account for post-59 growth because beer sales grew more than twice as fast as the number of people in this age group.

exhibit 3
Analysis of per capita beer demand in the United States, 1935–1963



Source: John G. Keane (Ph.D. diss., University of Pittsburgh).

Economies of scale

11 A major reason for the growth of national firms is the economies of scale obtained in their plant operations. Economies of scale in plant size enable brewers to obtain the lowest possible unit cost. According to Dr. Kenneth G. Elzinga of the University of Virginia (an authority on the brewing industry), the minimum efficient size (MES) plant capacity for the brewing industry is 1.25 million barrels per year. Cost savings accrue, from water-processing equipment, sewage facilities, refrigeration equipment, management, laboratories, and custodial cost reductions. Scale economies from most of these sources continue to plant capacities of 10 million barrels per year, but beyond the size of 4.5 million barrels, cost savings are negligible. Exhibit 4 shows one method used to estimate the extent of economies of scale: the survivor test.

exhibit 4
Surviving breweries by capacity: 1959–1973

Listed capacity barrels (000)	*1959*	*1961*	*1963*	*1965*	*1967*	*1969*	*1971*	*1973*
0–25	11	9	8	7	3	3	2	2
26–100	57	51	46	44	33	23	19	11
101–250	51	44	39	30	26	23	19	11
251–500	40	37	33	24	18	14	14	10
501–750	14	15	13	12	13	15	12	5
751–1,000	16	19	20	20	22	20	20	15
1,001–1,500	14	14	12	13	15	13	13	13
1,501–2,000	4	5	5	3	3	8	8	7
2,001–3,000	5	6	6	7	5	6	9	9
3,001–4,000	3	3	4	5	5	3	3	3
4,001+	2	2	3	3	4	7	7	11

Source: Compiled from plant capacity figures listed in the *Modern Brewery Age Book* (Stamford, Conn.: Modern Brewery Age Publishing Co., various years); and industry trade sources. These figures do not include plants listed only on a company-consolidated basis (in the case of multiplant firms) or single-plant firms not reporting capacity in the *Blue Book*. Most plants list their capacity.

12 Economies of scale played a central role in the restructuring of the brewing industry which led to the demise of hundreds of breweries between 1945 and 1970. Moreover, according to Charles F. Keithahn of the Bureau of Economics of the Federal Trade Commission, an analysis based solely on economies of scale would indicate a decline in firm concentration over the 1970s (in a world in which all plants are of minimum efficient size but no larger). Exhibit 5 shows the minimum market share a firm with a MES plant would need for survival.

exhibit 5
Economies of plant scale expressed as a percentage of total industry production for 1970, 1975, 1980

	Production (millions of barrels)	*MES plant as a percent of production*
1970	134.7	.9%
1975	150.3	.8
1980 (estimated)	176.8	.7

Source: Dr. Willard Mueller, from testimony before the Subcommittee on Antitrust and Monopoly of the Committee of the Judiciary, United States Senate, 95th Congress, 2d sess. (1978).

The effects of mergers on industry concentration

13 Leonard Weiss of the University of Wisconsin at Madison developed a means of delineating the impact of mergers on an industry's structure. Using his methodology, Dr. Elzinga found that mergers accounted for a negligible amount of the concentration occurring in the brewing industry. In fact, concentration trends in the brewing industry are rather unique in that most of the increased concentration was brought about by internal expansion rather than by merger or acquisition. Strict enforcement of the antitrust laws

by the Justice Department (DOJ) is the reason that mergers have accounted for such a small share of the increase in concentration. But the DOJ, through their rigid enforcement of the antitrust laws, may have promoted the end result they were seeking to prevent, increased national concentration. With the elimination of the merger route, the national brewers were forced to expand internally. They built large new breweries, which were more efficient than the older, smaller ones. If mergers had been permitted, the national firms might have acquired old, small breweries and might have grown slower than they actually did.

The effect of advertising

14 Forced to expand internally in a capital-intensive industry (it costs between \$25 and \$45 for each additional barrel of capacity), the national firms sought to ensure a steady demand for their products. The need for larger markets resulting from increased capacity coincided with the development of television which led to an increase in the firm's desired level of product identification. Advertising, particularly television spots, became the key to product differentiation in an industry where studies have shown that under test conditions beer drinkers cannot distinguish between brands. Exhibit 6 shows comparative advertising expenditures for 10 brewers. Exhibit 7 shows relative advertising effectiveness.

exhibit 6
Barrelage sold, measured media advertising expenditures, and advertising expenditures, per barrel, 10 leading brewers, 1972–1977

	Philip Morris-Miller			*Anheuser-Busch*		
Year	*Barrels (000)*	*Advertising* ($000)*	*A/B†*	*Barrels (000)*	*Advertising* ($000)*	*A/B†*
1977	24,410	$42,473	$1.74	36,640	$44,984	$1.23
1976	18,232	29,117	1.60	29,051	25,772	.89
1975	12,862	20,894	1.62	35,200	19,237	.55
1974	9,066	12,140	1.34	34,100	12,359	.36
1973	6,919	10,002	1.45	29,887	12,936	.43
1972	5,353	8,400	1.57	26,522	14,808	.56

	Schlitz			*Pabst*		
Year	*Barrels (000)*	*Advertising* ($000)*	*A/B†*	*Barrels (000)*	*Advertising* ($000)*	*A/B†*
1977	22,130	$40,830	$1.85	16,300	$10,843	$ .67
1976	24,162	33,756	1.40	17,037	9,112	.53
1975	23,279	23,173	1.00	15,700	9,007	.57
1974	22,661	17,977	.79	14,297	7,711	.54
1973	21,343	16,615	.78	13,128	6,422	.49
1972	18,906	17,782	.94	12,600	6,142	.49

exhibit 6 ***(continued)***

Year	Coors Barrels (000)	Coors Advertising* ($000)	Coors A/B†	Olympia (Hamm 1975) Barrels (000)	Olympia (Hamm 1975) Advertising* ($000)	Olympia (Hamm 1975) A/B†
1977	12,824	$ 3,966	$ .25	6,831	$ 8,470	$1.24
1976	13,665	1,626	.12	6,370	5,430	.85
1975	11,950	1,093	.09	5,770	5,555	.96
1974	12,400	801	.06	4,300	2,764	.64
1973	10,950	699	.06	3,636	2,323	.64
1972	9,785	1,332	.14	3,330	2,491	.75

Year	Heileman (Grain Belt 1975) Barrels (000)	Heileman (Grain Belt 1975) Advertising* ($000)	Heileman (Grain Belt 1975) A/B†	Stroh Barrels (000)	Stroh Advertising* ($000)	Stroh A/B†
1977	6,245	$ 4,636	$ .74	6,114	$ 7,212	$1.18
1976	5,210	3,616	.69	5,765	5,017	.87
1975	4,535	2,864	.63	5,133	3,950	.77
1974	4,300	2,329	.54	4,364	3,477	.80
1973	4,420	2,243	.51	4,645	3,145	.68
1972	3,675	2,260	.61	4,231	3,567	.84

Year	Schaefer Barrels (000)	Schaefer Advertising* ($000)	Schaefer A/B†	C. Schmidt Barrels (000)	C. Schmidt Advertising* ($000)	C. Schmidt A/B†
1977	4,700	$ 4,219	$ .90	3,571	$ 3,912	$1.10
1976	5,300	2,516	.47	3,450	2,703	.78
1975	5,881	2,637	.45	3,330	2,269	.68
1974	5,712†	2,308	.40	3,490	3,035	.87
1973	5,500	2,438	.44	3,520	2,916	.83
1972	5,530	2,994	.54	3,194	2,104	.66

* Advertising expenditures in six measured media as reported in *Leading National Advertisers*, various issues.

†Advertising per barrel.

Source: Company sales for 1970–76 from *Advertising Age*, various issues; 1977 sales, table 1.

exhibit 7

Relative media advertising effectiveness by beer brand, 1975–1978

	Media advertising expense ($ million)	*Total barrels (million)*	*Advertising expense per barrel*	*Barrel change 1978 versus 1974*	*Advertising expense per incremental million barrels*
Premium category					
Budweiser	$71.5	100.2	$ .71	1.1	$65.00
Miller High Life	60.5	61.3	.99	13.5	4.48
Schlitz	70.4	59.3	1.18	(5.2)	n.a.
Light category					
Lite	63.8	22.9	2.79	8.4	7.60
Anheuser-Busch					
Natural Light	24.0	3.8	6.32	2.3	10.43
Michelob Light	6.5	0.9	7.22	0.9	7.22
Schlitz Light	30.3	3.6	8.42	0.7	43.29
Super premium category					
Michelob	35.9	23.0	1.56	4.3	8.35
Lowenbrau	29.4	1.7	17.29	1.2	24.50

n.a. = Not available.

Source: C. James Walker III, *Competition in the U.S. Brewing Industry: A Basic Analysis* (New York: Shearson Hayden Stone, September 26, 1979).

15 In the last decade, a new rivalry has developed among major national brewers (this time at the instigation of Miller Brewing Company). In 1970, Philip Morris completed an acquisition of Miller, and according to Dr. Willard F. Mueller of the University of Wisconsin, Philip Morris's multiproduct and multinational operations in highly concentrated industries enabled it to engage in cross-subsidization of its brewing subsidiary. This capacity, coupled with the relatedness of the marketing function between Philip Morris and Miller, provided a powerful vehicle for industry restructuring. Miller adopted aggressive market segmentation and expansion strategies; thus increasing their capacity five-fold between 1970 and 1977. According to Dr. Mueller, a doubling of 1977 capacity is planned by 1981. Exhibit 8 shows comparative financial data on Philip Morris and the rest of the leading brewers.

exhibit 8
Assets, sales, net profit, net income on stockholders' investment, and total advertising expenditures, 1977 (millions)

Company	*Assets*	*Sales*	*Net profit*	*Total profit on equity*	*Total advertising*
Philip Morris (Miller)	$4,048	$3,849*	$335	19.8%	$277
Anheuser-Busch	1,404	1,838	92	13.5	79
Joseph Schlitz	727	937	20	5.5	55
Pabst Brewing	396	583	22	8.1	27
Adolph Coors	692	593	68	12.2	15‡
Total 2d to 5th	3,219	3,951	202	9.8†	176
Philip Morris as a percent of 2d to 5th	126%	97%	166%	202%	157%

*Excludes U.S. and foreign excise taxes.
†Unweighted average.
‡Estimate.
Source: "500 Largest Industrial," *Fortune*, May 1977; advertising data reported in individual company Security and Exchange Commission's from 10-K reports for 1977.

16 In 1975, Miller found a successful method for promoting a low-calorie beer, Lite, which they had purchased from Meister Brau, Inc., of Chicago in 1972. They spent heavily, around $6.00 per barrel, to introduce it nationwide. However, Lite's success was not wholly attributable to heavy advertising. Low-calorie beers were promoted in the past with a notable lack of success. Through marketing research, Miller discovered that a significant portion of the beer market is comprised of young and middle-aged men who are sports fans with dreams of athletic prowess. In advertising Lite, Miller relied predominantly on retired athletes renowned for their speed and agility. The message was that one could drink a lot of Lite and still be fast, not that one should drink Lite to keep from getting fat.

17 By 1975, Schlitz and to some extent, Anheuser-Busch, began to increase their own advertising expenditures and made plans to enter the low-calorie beer market. This was done not only as a response to Miller's aggressiveness, but also because of a general lack of growth in demand in the face of

increasing industry capacity. By 1978, 9 of the 10 largest brewers had light brands on the market. Exhibit 9 through Exhibit 11 show brand shipment breakdowns for the three major brewers.

18 Currently the only company with the financial resources to battle Miller and its multinational conglomerate backer is Anheuser-Busch, the industry leader. Anheuser-Busch responded aggressively to Miller's program. In 1977, Anheuser-Busch surpassed Miller and Schlitz in advertising expenditures by spending over $44 million.

19 Exhibit 12 shows market share performance for the top five brewers and all others in the 1974–1978 period.

exhibit 9

Estimated Anheuser-Busch brand breakdown: 1974–1978; shipments in barrels (millions)

	1978	*1977*	*1976*	*1975*	*1974*
Budweiser	27.5	25.4	21.1	26.2	26.4
Michelob	7.4	6.4	5.0	4.2	3.1
Michelob Light	0.9	—	—	—	—
Busch	3.5	3.3	3.0	4.8	4.6
Natural	2.3	1.5	—	—	—
Total	41.6	36.6	29.1	35.2	34.1

Source: C. James Walker III, *Competition in the U.S. Brewing Industry: A Basic Analysis* (New York: Shearson Hayden Stone, September 26, 1979).

exhibit 10

Estimated Miller brewing brand breakdown: 1974–1978; shipments in barrels (millions)

	1978	*1977*	*1976*	*1975*	*1974*
High Life	21.3	17.3	13.5	9.2	7.8
Lite	8.8	6.4	4.6	3.1	0.4
Lowenbrau	1.2	0.5	0.1	0.0	—
Other	0.0	0.0	0.2	0.5	0.9
Total	31.3	24.2	18.4	12.8	9.1

Source: C. James Walker III, *Competition in the U.S. Brewing Industry: A Basic Analysis* (New York: Shearson Hayden Stone, September 26, 1979).

exhibit 11

Estimated Schlitz brewing brand breakdown: 1974–1978; shipments in barrels (millions)

	1978	*1977*	*1976*	*1975*	*1974*
Schlitz	12.7	14.3	15.9	16.8	17.9
Old Milwaukee	4.3	4.9	5.5	5.2	3.9
Schlitz Light	0.7	1.3	1.4	0.2	—
Malt Liquor	1.7	1.4	1.3	1.0	0.8
Primo	0.2	0.2	0.1	0.1	0.1
Total	19.6	22.1	24.2	23.3	22.7

Source: C. James Walker III, *Competition in the U.S. Brewing Industry: A Basic Analysis* (New York: Shearson Hayden Stone, September 26, 1979).

exhibit 12
Market share performance

	1978				1977			
	Barrel shipments (million)	*Market share*	*Barrel increment (million)*	*Percent increase (decrease)*	*Barrel shipments (million)*	*Market share*	*Barrel increment (million)*	*Percent increase (decrease)*
Anheuser	41.6	25.1%	5.0	13.7%	36.6	22.9%	7.5	25.8%
Miller	31.3	18.9	7.1	29.3	24.2	15.2	5.8	31.5
Schlitz	19.6	11.8	(2.5)	(11.3)	22.1	13.9	(2.1)	(8.7)
Pabst	15.4	9.3	(0.6)	(3.8)	16.0	10.0	(1.0)	(5.9)
Coors	12.6	7.6	(0.2)	(1.6)	12.8	8.0	(0.7)	(5.2)
Top 5	120.5	72.7	8.8	7.9	111.7	70.0	9.5	9.3
All others	41.7	25.2	(3.5)	(7.7)	45.2	28.3	(3.0)	(6.2)
U.S. industry	162.2	97.9	5.3	3.4	156.9	98.4	6.5	4.4
Imports	3.45	2.1	0.8	30.8	2.6	1.6	0.2	8.3
All beer	165.6	100.0	6.1	3.8	159.5	100.0	6.7	4.5

	1976				1975			
	Barrel shipments (million)	*Market share*	*Barrel increment (million)*	*Percent increase (decrease)*	*Barrel shipments (million)*	*Market share*	*Barrel increment (million)*	*Percent increase (decrease)*
Anheuser	29.1	19.0%	(6.1)	(17.3)%	35.2	23.4%	1.1	3.2%
Miller	18.4	12.0	5.6	43.8	12.8	8.5	3.7	40.7
Schlitz	24.2	15.8	0.9	3.9	23.3	15.5	0.6	2.6
Pabst	17.0	11.1	1.3	8.3	15.7	10.4	1.4	9.8
Coors	13.5	8.8	1.6	13.4	11.9	7.9	(0.4)	(3.3)
Top 5	102.2	66.9	3.3	3.3	98.9	65.8	6.4	6.9
All others	48.2	31.5	(1.5)	(3.0)	49.7	33.1	(3.3)	(6.2)
U.S. industry	150.4	98.4	1.8	1.2	148.6	98.9	3.1	2.1
Imports	2.4	1.6	0.7	41.2	1.7	1.1	0.3	21.4
All beer	152.8	100.0	2.5	1.7	150.3	100.0	3.4	2.3

	1974		1974–1978		
	Barrel shipments (million)	*Market share*	*Increased barrel shipments (million)*	*Market share point change*	*Compounded annual shipment growth*
Anheuser	34.1	23.2%	7.5	+ 1.9	5.1%
Miller	9.1	6.2	22.2	+12.7	36.2
Schlitz	22.7	15.4	(3.1)	− 3.6	(3.3)
Pabst	14.3	9.7	1.1	− 0.4	1.9
Coors	12.3	8.4	0.3	− 0.8	0.4
Top 5	92.5	63.0	28.0	+ 9.7	6.8
All others	53.0	36.0	11.3	−10.8	(4.9)
U.S. industry	145.5	99.0	16.7	− 1.1	2.7
Imports	1.4	1.0	2.0	+ 1.1	24.9
All beer	146.9	100.0	18.7	0.0	3.1

Source: C. James Walker III, *Competition in the U.S. Brewing Industry: A Basic Analysis* (New York: Shearson Hayden Stone, September 26, 1979).

20 Clearly, Anheuser-Busch's and Miller's growth has been at the expense of the regional brewers and the faltering national brewers (Schlitz and Pabst). C. James Walker III, an industry analyst for Shearson Hayden Stone, Inc., estimates only 2.7 percent per year industry growth for the early 1980s. The capital-intensive nature of the industry, coupled with huge advertising outlays, make it very unlikely that any firm will be able to challenge the two leaders. To quote August Busch III, "This business is now a two-horse race."

Organization of Anheuser-Busch

21 Effective October 1, 1979, Anheuser-Busch, Inc., became a wholly owned subsidiary of a new holding company, Anheuser-Busch Companies, Inc., and the outstanding shares of Anheuser-Busch, Inc., were exchanged for an equal number of shares of the holding company. Concerning this change, August A. Busch III said,

> The holding company's name and structure will more clearly communicate the increasingly diversified nature of our business, thereby reflecting not only our position of leadership in the brewing industry, but also our substantial activities in yeast and specialty corn products, family entertainment, transportation, can manufacturing, real estate, and other businesses. The new structure will also provide management with increased organizational and operational flexibility.
>
> Each of our businesses can eventually be operated as separate companies under Anheuser-Busch Companies, Inc., with responsibilities divided among management personnel.
>
> This reorganization will help facilitate our long-range plan to not only continue to grow in production and sales of beer but also to continue to expand and diversify into other areas which offer significant opportunities for growth.

22 Additionally, Busch announced that Fred L. Kuhlmann, executive vice president, had been elected vice chairman of the board of Anheuser-Busch Companies, Inc., and that Dennis P. Long had been elected president and chief operating officer of Anheuser-Busch, Inc., a subsidiary of the holding company. Long has overall responsibility for the conduct of the company's beer business, and he reports to Busch. (Busch is chairman and chief executive officer of Anheuser-Busch, Inc.)

23 Also, Long was elected a member of the corporate office of Anheuser-Busch Companies, Inc. Three individuals comprise the corporate office. They are Busch, Kuhlmann, and Long. Kuhlmann and Long consult with Busch on major corporate matters and they assist him in implementing corporate policy.

24 Busch announced that the operating executives of two other divisions and subsidiaries have been named presidents of their respective operating units. W. Robert Harrington was named president of Industrial Products, and W. Randolph Baker was named president of Busch Gardens.

Key executives[1]

25 August A. Busch III was born June 16, 1937, attended public and private schools in St. Louis, the University of Arizona, and the Siebel Institute of Technology, a school for brewers in Chicago. He is chairman of the board and president of Anheuser-Busch Companies, Inc., and he began his career with the company in 1957 in the St. Louis Malt House. Since that time, he has worked in practically every department of both the brewing and operations divisions. In 1962, he moved into marketing, working in the field with wholesalers, as well as company-owned branches in all areas of the country. Returning to St. Louis, he was promoted to assistant sales manager—regional brands and later was named sales manager for regional brands where he was responsible for the marketing of Busch throughout the product's marketing area.

26 Busch was named a member of the company's board of directors and appointed vice president—marketing operations in 1963. He became general manager in July 1965; executive vice president and general manager in April 1971; president in February 1974; chief executive officer in May 1975; and chairman of the board in April 1977.

27 Fred L. Kuhlmann, a native of St. Louis, is vice chairman of the board of directors and executive vice president of Anheuser-Busch Companies, Inc. He joined Anheuser-Busch, Inc., in August 1967 as general counsel and was elected a vice president in January 1971; senior vice president—administration and services, and member of the board of directors in February 1974; executive vice president—administration in June 1977; and was elected to his present position in October 1979.

28 Kuhlmann received his A.B. degree from Washington University in St. Louis and his LL.B. from that institution's school of law. He also has an LL.M. degree from Columbia University School of Law in New York. He has been active in a number of business and civic groups and serves as a director of the St. Louis National Baseball Club, Inc. and Manufacturers Railway Company. He is also a director of Boatmen's National Bank of St. Louis, Civic Center Redevelopment Corporation, and St. Louis Regional Commerce and Growth Association.

29 Dennis P. Long, 44, president of Anheuser-Busch, Inc., has extensive experience spanning more than 25 years at Anheuser-Busch both in brewing and nonbrewing areas, and he attended Washington University in St. Louis, Missouri. After serving as national price administrator in beer marketing from 1960 to 1964, he was promoted to assistant to the vice president of beer marketing operations and worked in the field with the nationwide beer wholesaler network as well as with company-owned branch distribution centers. He was promoted to assistant to the vice president and general manager in 1965.

[1] The information presented in this section was obtained from the corporate headquarters of Anheuser-Busch Companies, Inc.

30 In 1972, Long was elected group vice president responsible for the Busch Gardens and industrial products division and Busch Properties, Inc. Under Long's leadership, the industrial products division became the nation's leading producer of bakers' yeast; the division's sales of both yeast and corn products and profitability increased to record proportions. He also headed the transition of Busch Gardens from beer promotional facilities to a separate profit center. Since then, a new Busch Gardens has been opened in Williamsburg, Virginia, and that division also operates profitably. Since taking charge of Busch Properties, Inc., the real estate subsidiary has embarked further into residential and resort development in addition to the commercial-industrial field, and the performance of Busch Properties has improved markedly.

31 In June 1977, Long became vice president and general manager of the beer division, and since that time has embarked upon a strong effort to increase beer sales volume and profitability. His efforts include new and expanded marketing efforts; increased productivity in brewing and packaging; and a strong cost control and cost reduction effort.

Products offered by Anheuser-Busch

32 Over the past five years, Anheuser-Busch's beer division has accounted for approximately 90 percent of consolidated net sales. The beer division of Anheuser-Busch produces Budweiser, Michelob, Busch, Michelob Light, Classic Dark, and Anheuser-Busch Natural Light. The remaining 10 percent of the consolidated net sales come from family entertainment (Busch Gardens division), can manufacturing, container recycling, transportation services (St. Louis Refrigerator Car Company and Manufacturers Railway Company), major league baseball (St. Louis Cardinals), real estate development (Busch Properties, Inc.), and the manufacture and sale of corn products, brewer's yeast, and bakers' yeast (industrial products division). Anheuser-Busch is the nation's leading producer of bakers' yeast with a market share well over 40 percent. Exhibit 13 presents data by product line.

33 During 1978, Anheuser-Busch made significant progress in redefining its diversification objectives as a means of building for the future. A corporate policy was established to concentrate initially on developing new food and beverage products which are compatible with the existing capabilities and, where possible, on distributing these products through the company's existing wholesaler network. The company is presently working on developing a line of snack foods, reportedly called Eagle Snacks, which would also be compatible with existing production and distribution facilities.

34 The company began test marketing Würzburger Hofbräu beer in the United States early in 1979. This full-bodied, premium, German beer will be brewed in Wurzburg, West Germany and shipped in large insulated barrels to the United States where it will be bottled by Anheuser-Busch and distributed through the company's wholesaler network.

exhibit 13
Revenue generated by product class ($000)

	1978	*1977*	*1976*	*1975*	*1974*
Consolidated sales	$2,701,611	$2,231,230	$1,752,998	$2,036,687	$1,791,863
Federal and state beer taxes	441,978	393,182	311,852	391,708	378,772
Consolidated net sales	$2,259,633	$1,838,048	$1,441,146	$1,644,979	$1,413,091
Beer division	2,056,754	1,691,004	1,282,620	1,480,481	1,271,782
Percent of consolidated net sales	91%	92%	89%	90%	90%
Other divisions*	$ 202,879	$ 147,044	$ 158,526	$ 164,498	$ 141,309
Percent of consolidated net sales	9%	8%	11%	10%	10%

*All other divisions include: industrial products division; Busch Gardens division; Busch Properties, Inc.; transportation; and the St. Louis Cardinals.

Source: Anheuser-Busch Company, Inc., annual reports, 1974–1978.

35 Anheuser-Busch has a new installation in St. Louis, Missouri, which annually produces 1.8 million pounds of autolyzed yeast extract, a flavoring agent for processed foods. As the only producer of the extract in the United States with its own captive supply of brewer's yeast, Anheuser-Busch entered this new venture with a decided competitive advantage.

36 Anheuser-Busch's well-known family of quality beers includes products in every market segment. Budweiser has been brewed and sold for more than 100 years. Premium Bud, available in bottles, cans, and on draught nationwide, is the company's principal product and the largest selling beer in the world. Michelob was developed in 1896 as a "draught beer for connoisseurs." Super-premium Michelob is sold nationally in bottles, cans, and on draught.

37 With a greater percentage of the population entering the weight-conscious 25–39-year-old range, Anheuser-Busch has introduced Michelob Light. It has 20 percent fewer calories than regular Michelob. When introduced in 1978, it was the first super-premium light beer. In order to capitalize on this by transferring the consumer appeal for Michelob to Michelob Light, Anheuser-Busch communicates "the heritage of Michelob and the taste of Michelob Light," in its advertising. Michelob Light is available nationwide in cans, bottles, and on draught. Anheuser-Busch also offers Natural Light for weight-conscious beer drinkers.

38 Busch Bavarian beer was introduced in 1955 as a low-priced beer in direct competition with subpremium regional beers. In April 1978, a smoother, sweeter, and lighter Busch beer was successfully test marketed in New England as a premium-priced brand to capitalize on anticipated growth of the premium segment of the market in future years. In 1979, with new package graphics and advertising, premium Busch was introduced in areas where the company previously marketed Busch Bavarian.

39 Anheuser-Busch's expanding corporate programs of vertical integration into can manufacturing and barley malting play an important role in overall beer division activities and profitability. The company's various vertically integrated enterprises provide an added advantage in controlling the cost and supply of containers and ingredients. Vertical integration helps to reduce cost pressures in brewing operations and to ensure continuity and quality of supply.

40 Metal Container Corporation, a wholly-owned subsidiary of Anheuser-Busch Companies, produces two-piece aluminum beer cans at facilities in Florida, Ohio, and Missouri. Container Recovery Corporation, another wholly-owned subsidiary of Anheuser-Busch Companies, operates container recovery facilities in Ohio and New Hampshire which are actively involved in collecting and recycling aluminum cans.

41 The company's materials acquisition division is responsible for purchasing all agricultural commodities, packaging materials, supplies, and fuel. Its objective is to increase stability and flexibility in the procurement of commodities and materials. This division investigates alternative methods of supply, analyzes vertical integration opportunities available to the company, and monitors the supply and cost of all commodities purchased by Anheuser-Busch.

42 Anheuser-Busch processes barley into brewer's malt at plants in Manitowoc, Wisconsin (total capacity of 8.5 million bushels annually) and Moorhead, Minnesota (annual capacity of 6.4 million bushels). These two malt production facilities provide the company with the capability to self-manufacture approximately one third of its malt requirements.

43 The industrial products division produces corn syrup and starch for numerous food applications, including the processing of canned frozen foods and the manufacture of ice cream and candy. Additionally, the division markets starch and resin products used in the manufacture of paper, corrugated containers, and textiles. The company's corn processing plant in Lafayette, Indiana currently has a grind capacity of 11 billion bushels of corn yearly.

44 The company's brewer's yeast food plant in Jacksonville, Florida has a yearly capacity of 3 million pounds. The debitterized brewer's food yeast is sold to health food manufacturers for use in a variety of nutritional supplements. Busch Entertainment Corporation, the company's family entertainment subsidiary, operates theme parks in Florida and Virginia. Unique blends of natural beauty and family entertainment activities and attractions are featured in both locations. Busch Properties, Inc., is the company's real estate development subsidiary. It is currently involved in the development of both residential and commercial properties at sites in Virginia and Ohio. St. Louis Refrigerator Car Company, Manufacturers Railway Company, and five other companies compose Anheuser-Busch's transportation subsidiaries. They provide commercial repair, rebuilding, maintenance and inspection of railroad cars, terminal railroad switching services, and truck cartage and warehousing services.

Marketing

45 Anheuser-Busch has a coast-to-coast network of 11 breweries which are selectively situated in major population and beer consumption regions. Once the beers leave the breweries, distribution to the consumer becomes the responsibility of 959 wholesale distribution operations and 11 company-owned beer branches which provide the company with its own profit centers within the distribution system. The beer branches perform sales, merchandising, and delivery services in their respective areas of primary responsibility. The company's beer branches are located in Sylmar and Riverside, California; Denver, Colorado; Chicago, Illinois; Louisville, Kentucky; New Orleans, Louisiana; Cambridge, Massachusetts; Kansas City, Missouri; Newark, New Jersey; Tulsa, Oklahoma; and Washington, D.C.

46 The beer industry has always been a highly competitive industry. Success depends on volume, and sales by the nation's top five brewers account for an estimated 70 percent of the total market. There is intense competition between the industry leaders. According to *Value Line,* it is expected that, by 1980, the top five brewers will account for approximately 80 percent of the market.

47 Competitive pressures have led Anheuser-Busch to take an aggressive stance in its marketing strategy. Anheuser-Busch is the country's largest brewer in terms of barrel sales per year and the 34th largest national advertiser. The 1978 annual report of Anheuser-Busch said their marketing efforts were "the most extensive and aggressive in company history," stressing product and packaging innovations, brand identity, and off-premise merchandising. The company is entering the 1980s with new packaging innovations and new marketing programs. The aggressive packaging is aimed at further market segmentation and penetration. Presently, the company sells more than 80 basic packages.

48 Anheuser-Busch's advertisements have traditionally been aimed at communicating the quality of the company's beer products which appeal to virtually every taste and price range. Television advertisements and sports sponsorships continue to be the major focal point for marketing the company's beer brands. Television advertisements focus on prime-time programming and sports. To increase its presence on college campuses, Anheuser-Busch utilizes a unique marketing team of 400 student representatives at major colleges and universities across the country.

49 Anheuser-Busch has enlarged its marketing staff in the beer division. A field sales task force has been established to provide immediate and concentrated assistance in markets needing a sales boost. The national accounts sales department was created to provide better marketing coordination and communication between the company's sales staff and large national chain accounts such as grocery stores, convenience stores, fast-food outlets, hotels, motels, liquor chains, and athletic stadiums. The marketing services department coordinates and expands activities in the areas of sales promotion, merchandising, special markets, point-of-sale, and incentive programs.

Production facilities

50 Reviewing the production facilities utilized by Anheuser-Busch provides insight into the growth pattern of the organization. Devotion to investment in plant capacity has been extensive in the past decade, and the future capital expenditure program allows for further expansion and modernization of facilities (annual report, 1978).

51 The largest subsidiary of Anheuser-Busch Companies is the beer production sector. Exhibit 14 is a listing of the geographically dispersed breweries with their corresponding annual capacity in millions of barrels and dates of first shipments.

exhibit 14
Production facility locations and capacities

	Millions barrels	*Beginning of shipment*
St. Louis, Missouri	11.6	1880
Los Angeles, California	10.0	1954
Newark, New Jersey	4.7	1951
Tampa, Florida	2.2	1959
Houston, Texas	2.6	1966
Columbus, Ohio	6.2	1968
Jacksonville, Florida	6.5	1969
Merrimack, New Hampshire	2.8	1970
Williamsburg, Virginia	7.5	1972
Fairfield, California	3.5	1976
Baldwinsville, New York	6.0	1982

Source: Anheuser-Busch annual reports.

52 As can be seen from this exhibit, many of the beer production facilities are quite new. Plants in St. Louis and Newark have undergone extensive modernization programs to upgrade older plants and equipment and ensure consistent quality regardless of brewery location. In 1980, Anheuser-Busch purchased a brewery formerly owned and operated by Schlitz. The seller was forced to close the plant as a result of declining sales due to competitive pressures.

53 Commitments to plant expansion have been extensive in the past few years. For example, capital expenditures will approach $2 billion for the five years ending 1983, with 93 percent for beer-related activities, according to industry analyst Robert S. Weinberg. Expansion is currently being undertaken at several of the 11 breweries. At the Los Angeles plant, the largest expansion project, capacity is being increased by more than 6 million barrels. Capacity in Williamsburg, Virginia, is being increased threefold.

54 Plant expansion in the areas of can manufacturing and industrial products manufacturing is being conducted at rapid rates. Vertical integration into can manufacturing and malt production is requiring substantial increases in plant

investment. Can production facilities were completed in Jacksonville, Florida in 1974, Columbus, Ohio, in 1977, and a new plant will be completed in 1980 in Arnold, Missouri. Nearly 40 percent of cans used will be provided internally by 1980. In addition, two can recycling facilities are currently in operation.

Research and development

55 According to the 1978 Securities and Exchange Commission's form 10-K report, Anheuser-Busch "does not consider to be material the dollar amounts expended by it during the last two fiscal years on research activities relating to the development of new products or services or the improvement of existing products or services. In addition, the company does not consider the number of employees engaged full time in such research activities to be material." The company is, however, extensively involved in research and development.

56 R&D funds are currently being used to develop new food and beverage products which are consistent with the company's production and distribution capabilities. The organization has a corn products research group which recently developed a number of new and very profitable modified food starches. In addition to these, Anheuser-Busch's research on possible new beer products helped to place Michelob Light and Anheuser-Busch Natural Light beers on the market.

57 Along with research on new and profitable products, the company is striving to cut packaging costs by doing research in the production of aluminum. Anheuser-Busch paid $6 million in 1978 to a major international aluminum company, Swiss Aluminum Ltd., for access and participation rights in this company's ongoing research in the development of certain new technologies in aluminum casting. This area should greatly reduce costs in the future.

58 Besides product and container research, Anheuser-Busch's R&D departments are studying matters of social concern. The reasons for this type of research are, first, so the company can remain active in its social responsibility as a public corporation, and also to strengthen its influence in reducing government regulations and thus avoid possible costly restrictions to its operations. Research to determine the causes of alcoholism and develop effective treatment and prevention programs, in cooperation with the United States Brewers Association, is one example of the company's effort here. Other examples relate to environmental matters. In an independent effort toward developing and utilizing alternative energy systems, other than scarce natural gas and oil, Anheuser-Busch is researching solar energy. In 1978, the company installed a new pilot project at its Jacksonville, Florida brewery. At this plant, solar energy is being tested in pasteurizing bottled beers. In addition to this, the company is developing new land application

programs aimed at soil enrichment and energy conservation. Under these programs, rich soil nutrients are taken from the breweries' liquid wastes and used to grow various crops, primarily sod, grass, and grains.

Money matters at Anheuser-Busch

59 Exhibits 15, 16, 17, and 18 contain relevant financial data on Anheuser-Busch.

Future

60 In his letter to the shareholders in the 1978 annual report, August A. Busch III discusses Anheuser-Busch's expansion and diversification plans. He writes,

> We continue to commit substantial resources to provide the capacity necessary to support our planned sales growth and to maintain our industry leadership. Future growth and profitability also depend, however, on our willingness to commit funds and energies to the development of new products and new areas of business activity.
>
> For a number of years, we have been investing considerable sums of money and a great deal of effort in the area of vertical integration of our beer business . . . new can and malt plants and, more recently, in exploring the possibility of producing our own aluminum sheet used in the manufacture of cans. These activities have proved to be successful in controlling costs and we will continue to pay close attention to vertical integration.
>
> We are also exploring opportunities to diversify into other business ventures which are not beer related. We can do this either through acquisitions or through internal development of new products. At the present time we are emphasizing a program aimed at maximizing use of existing capabilities. We are in the process of developing interally a line of soft drinks and other consumer products which can be distributed through our wholesale net-

exhibit 15
Per share data ($)

Year end December 31	*1978*	*1977*	*1976*	*1975*	*1974*	*1973*	*1972*	*1971*	*1970*	*1969*
Book value	16.71	15.07	13.72	13.17	11.93	11.11	10.25	9.20	8.02	7.03
Earnings[1]	2.46	2.04	1.23	1.88	1.42	1.46	1.70	1.60	1.40	1.01
Dividends	0.82	0.71	0.68	0.64	0.06	0.60	0.58	0.53	0.42½	0.40
Payout ratio	33%	35%	55%	34%	42%	41%	34%	33%	30%	39%
Prices—High	27¾	25¼	38⅝	39⅝	38	55	69	57½	39⅝	36⅞
Low	17½	18¾	20¾	24½	21	28⅝	51	37	27⅛	28½
Price-earnings ratio	11-7	12-9	31-17	21-13	27-15	38-20	41-30	36-23	28-19	36-28

Data as originally reported. Adjusted for stock dividends of 100 percent April 1971.
[1] Before results of discontinued operations of—0.09 in 1972.
Source: *Standard OTC Stock Reports*, 46, no. 125, sec. 5, (October 31, 1979). Copyright © 1979 Standard & Poor's Corporation. All rights reserved.

exhibit 16

Income data ($ millions)

Year ended December 31	Revenues	Operating income	Percent operating income of revenues	Capital expenditures	Depreciation	Interest expense	Net before taxes[3]	Effective tax rate	Net income[4]	Percent net income of revenues
1978	2,260	288	12.8%	229	66.0	28.9	206	46.0%	111	4.9%
1977	1,838	246	13.4	157	61.2	26.7	170	45.9	92	5.0
1976	1,441	181	12.6	199	53.1	26.9	103	46.4	55	3.8
1975	1,645	226	13.8	155	51.1[2]	22.6	165	48.7	85	5.2
1974	1,413	164	11.6	126	45.0	11.9	122	47.3	64	4.5
1973	1,110	162	14.6	92	41.1	5.3	126	48.1	66	5.9
1972[1]	978	184	18.8	84	39.0	6.0	147	48.0	76	7.8
1971	902	170	18.9	73	35.0	6.6	136	47.3	72	7.9
1970	793	155	19.5	65	33.8	7.1	121	48.2	63	7.9
1969	667	122	18.2	71	30.1	7.4	93	51.2	45	6.8

[1] Before results of discontinued operations of—0.09 in 1972.
Source: *Standard OTC Stock Reports*, 46, no. 125, sec. 5 (October 31, 1979). Copyright © 1979 Standard & Poor's Corporation. All rights reserved.

exhibit 17

Balance sheet data ($ million)

December 31	Cash	Current Assets	Current Liabilities	Current Ratio	Total assets	Return on assets	Long-term debt	Common equity	Total capital	Percent long-term debt of capital	Return on equity
1978	196	492	255	1.9	1,648	7.3%	427	754	1,393	30.7%	15.5%
1977	154	400	212	1.9	1,404	6.9	337	680	1,191	28.3	14.0
1976	135	347	167	2.1	1,268	4.5	341	618	1,101	30.9	9.1
1975	224	420	161	2.6	1,202	7.9	342	594	1,041	32.9	15.0
1974	89	252	113	2.2	931	7.5	193	538	818	23.6	12.3
1973	60	176	100	1.8	765	9.0	93	501	666	14.0	13.6
1972[1]	69	166	81	2.0	698	11.3	99	462	617	16.1	17.4
1971	69	163	75	2.2	654	11.3	117	414	579	20.1	18.5
1970	61	158	78	2.0	605	10.8	128	358	527	24.3	18.6
1969	45	142	65	2.2	550	8.4	135	314	485	27.8	15.1

[1] Before results of discontinued operations of—0.09 in 1972.
Source: *Standard OTC Stock Reports*, 46, no. 125, sec. 5 (October 31, 1979). Copyright © 1979 Standard & Poor's Corporation. All rights reserved.

exhibit 18
Ten-year financial summary (In $000, except per share and statistical data)

Consolidated summary of operations:	*1978*	*1979*	*1976*
Barrels sold	41,610	36,640	29,051
Sales	$2,701,611	$2,231,230	$1,752,998
Less federal and state beer taxes	441,978	393,182	311,852
Net sales	2,259,633	1,838,048	1,441,146
Cost of products sold	1,762,410	1,462,801	1,175,055
Gross profit	497,223	375,247	266,091
Less marketing, administrative, and research expenses	274,961	190,470	137,797
Operating income:	222,262	184,777	128,294
Interest income	11,693	7,724	10,304
Interest expense	(28,894)	(26,708)	(26,941)
Other income net	751	4,193	1,748
Loss on partial closing of Los Angeles Busch Gardens (1)			10,020
Income before income taxes	205,812	169,986	103,385
Income taxes	94,772	78,041	47,952
Income before extraordinary item	111,040	91,945	55,433
Extraordinary item (2)			
Net income	$ 111,040	91,945	$ 55,433
Per share (3)			
Income before extraordinary item	2.46	2.04	1.23
Net income	2.46	2.04	1.23
Cash dividends paid	37,013	32,036	30,646
Per share (3)	.82	.71	.68
Dividend payout ratio	33.3%	34.8%	55.3%
Average number of shares outstanding (3)	45,138	45,115	45,068
Book value per share	16.71	15.07	13.72
Balance sheet information:			
Working capital	236,396	188,069	194,814
Current ratio	1.9	1.9	2.2
Plant and equipment, net	1,109,243	951,965	857,073
Long-term debt	427,250	337,492	340,737
Debt to debt plus total equity	34.5%	31.7%	34.0%
Deferred income taxes	153,080	125,221	99,119
Deferred investment tax credit	58,053	48,371	43,174
Shareholders' equity	754,423	680,396	618,429
Return on shareholders' equity	15.1%	14.2%	9.2%
Other information:			
Capital expenditures	228,727	156,745	198,735
Depreciation	66,032	61,163	53,105
Total payroll cost	421,806	338,933	271,403
Effective tax rate	46.0%	45.9%	46.4%

Notes to 10-year financial summary:

(1) In December 1976, the company decided to close a portion of the Los Angeles Busch Gardens and convert the remainder to a sales promotion facility. Closing a portion of the Gardens resulted in a nonoperating charge of $10,020,000 (before reduction for income tax benefits of approximately $5 million). This nonoperating charge, which reduced earnings per share by 11 cents, has been reported in accordance with *Accounting Principles Board Opinion No. 39* which was effective September 30, 1973.

exhibit 18 ***(concluded)***

1975	1974	1973	1972	1971	1970	1969
35,196	34,097	29,887	26,522	24,309	22,202	18,712
$2,036,687	$1,791,863	$1,442,720	$1,273,093	$1,173,476	$1,036,272	$871,904
391,708	378,772	333,013	295,593	271,023	243,495	205,295
1,644,979	1,413,091	1,109,707	977,500	902,453	792,777	666,609
1,343,784	1,187,816	875,361	724,718	658,886	579,372	490,932
301,195	225,275	234,346	252,782	243,567	213,405	175,677
126,053	106,653	112,928	108,008	108,087	92,660	84,113
175,142	118,622	121,418	144,774	135,480	120,745	91,564
10,944	9,925	4,818	3,299	3,102	3,715	3,604
(22,602)	(11,851)	(5,288)	(6,041)	(6,597)	(7,104)	(7,401)
1,816	4,840	5,287	4,855	4,065	3,420	5,171
165,300	121,536	126,235	146,887	136,050	120,776	92,938
80,577	57,517	60,658	70,487	64,412	58,227	47,627
84,723	64,019	65,577	76,400	71,638	62,549	45,311
			4,093			
$ 84,723	$ 64,019	$ 65,577	$ 72,307	$ 71,638	$ 62,549	$ 45,311
1.88	1.42	1.46	1.70	1.60	1.40	1.02
1.88	1.42	1.46	1.61	1.60	1.40	1.02
28,843	27,041	27,037	26,109	23,784	18,991	17,843
.64	.60	.60	.58	.53	.425	.40
34.0%	42.3%	41.1%	36.0%	33.1%	30.4%	39.2%
45,068	45,068	45,063	45,020	44,887	44,686	44,616
13.17	11.93	11.11	10.25	9.20	8.02	7.03
268,099	145,107	82,352	88,711	92,447	85,102	80,963
2.7	2.3	1.8	2.1	2.2	2.1	2.3
724,914	622,876	541,236	491,671	453,647	416,660	387,422
342,167	193,240	93,414	99,107	116,571	128,080	134,925
35.6%	25.7%	15.3%	17.2%	21.4%	25.6%	29.2%
80,748	66,264	54,281	41,456	34,103	27,274	23,212
24,293	21,157	17,225	14,370	14,276	13,563	12,577
593,642	537,762	500,784	461,980	413,974	358,476	314,121
15.0%	12.3%	13.6%	16.5%	18.6%	18.6%	15.1%
155,436	126,463	91,801	84,217	73,214	65,069	66,396
51,089	45,042	41,059	38,970	34,948	33,795	30,063
268,306	244,437	221,049	190,517	176,196	156,576	133,872
48.7%	47.3%	48.1%	48.0%	47.3%	48.2%	51.2%

(2) In December 1972, the company decided to close a portion of the Houston Busch Gardens and convert the remainder to a sales promotion facility. Closing a portion of the Gardens resulted in an extraordinary aftertax charge against 1972 earnings of $4,093,000, or 9 cents per share, net of applicable income tax benefits of $4,006,000.

(3) Per share statistics have been adjusted to give effect to the two-for-one stock split in 1971.

Source: Anheuser-Busch Companies Inc., annual reports, 1969–1978.

exhibit 19
Estimated volume by brewer 1978 and 1981

	1978		*1981**		*1978–1981*	
	Barrel shipments (millions)	*Market share*	*Barrel shipments (millions)*	*Market share*	*Barrel increment (millions)*	*Compounded annual rate of growth*
Anheuser-Busch	41.6	25.1%	51.5	28.7%	+ 9.9	7.4%
Miller	31.3	18.9	44.9	25.0	+13.6	12.6
Schlitz	19.6	11.8	17.2	9.6	− 2.4	(3.8)
Pabst	15.4	9.3	14.7	8.2	− 0.7	(1.2)
Coors†	12.6	7.6	17.2	9.6	+ 4.6	11.1
Top 5	120.5	72.8	145.5	81.1	+25.0	6.6
All others‡	41.7	25.2	28.4	15.8	−13.3	(9.7)
U.S. industry	162.2	97.9	173.9	97.0	+11.7	2.3%
Imports	3.4	2.1	5.4	3.0	+ 2.0	16.5
All beer	165.6	100.0%	179.3	100.0%	+13.7	2.7%

*Estimated.
†Coors was in a 16-state market in 1978 and an estimated 19-state market in 1981 (additions: Arkansas, Louisiana, and Minnesota).
‡In 1981, the operations of Blitz-Weinhard are included with Pabst; in 1978, about 600,000 barrels of Blitz are in the all-other group.
Source: C. James Walker III, *Competition in the U.S. Brewing Industry: A Basic Analysis* (New York: Shearson Hayden Stone, September 26, 1979).

work. We recognize from the outset that we may not achieve success in every one of these new ventures. However, the financial risks are relatively small and the potential rewards are considerable.

61 C. James Walker III, an industry analyst, believes that Anheuser-Busch expects a 1981 shipment level of 55 million barrels indicating 9.2 million barrel growth in the 1979–1981 period. This is comparable to what should be achieved in 1977–1979. However, without the presence of a visible new major category similar to "Light" in size, Walker doubts that growth in the 1980s can match the expansion of the late 1970s. According to Walker, new brands such as Würzburger and Busch Premium seem unlikely to garner the growth that Natural Light and Michelob Light may attain. Exhibit 19 shows Walker's estimates for 1981, which would make Anheuser-Busch fall 6 percent shy of its goal of 98 percent capacity utilization.

62 Busch, on the other hand, is more optimistic. He writes,

> In anticipation of what we can expect to encounter in the marketplace, we have developed strong and aggressive marketing and promotion programs to enhance our position as industry leader. We will be introducing more new products and new packages to keep Anheuser-Busch in the forefront of market segmentation. And, we will be intensifying our emphasis on the quality of our products.
>
> Competitive pressures will demand the most dedicated and creative efforts that we can muster, but we are confident that with: our strong sales momentum, our quality products, our great wholesaler family, and the team effort of our employees, we will have another successful year and will continue to build a solid corporate foundation for future growth and profits.

section D

Opportunity analysis and strategic choice

case 14

The Southland Corporation

1 In 1978, the world's largest chain of convenience food stores was 7-Eleven markets, a division of the Southland Corporation. The 7-Eleven chain started from very humble beginnings in 1927 to surpass the $3 billion sales figure in 1978. Southland showed all indications of continuing its 15 percent annual growth rate and capitalizing on consumer acceptance of convenience shopping. As the president of a rival chain expressed it, "I think it has to be said that Southland is one of the great retailing stores of our time."

Company history

2 In 1924, Jodie Thompson wanted to get married, but his $40-a-week salary from a Dallas ice-making firm was not enough to support a wife and family. From working on the ice docks and overseeing sales that summer, Thompson came upon the solution—chilled watermelons. No one had ever tried to sell chilled watermelons (or any other retail item for that matter) off the ice docks in Texas. Thompson's boss was initially very skeptical, but finally gave approval to try the idea. The venture was a success, and by the end of the summer, Thompson had made $2,300.

3 In the summer of 1927, one of the dock managers of the Southland Ice Co. found that he could do a much brisker business by staying open 16 hours a

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This case was prepared by Dr. John Thiel and Jim Brown, University of Tennessee.

day, seven days a week. He also noted that late-hour ice customers often complained about there being no place to pick up a loaf of bread or a bottle of milk. The dock manager persuaded Thompson, who by then was secretary-treasurer and a director of Southland Ice Co., to finance an inventory of bread, milk, and eggs and stack them on the dock. The items sold well, and shortly thereafter, when Thompson became president, all the company's ice docks were stocked with grocery items and the enterprising dock manager was assigned the task of finding new store sites. At the advice of a local advertising agency, Thompson named the stores 7-Eleven because they were open from 7A.M. to 11 P.M.

4 By the mid-1950s, Southland had expanded to about 300 stores, mostly in Texas and Florida. As the United States became more urbanized, with many people commuting to work from the suburbs, Thompson and his two oldest sons believed that Southland could move into and redefine the niche once dominated by mom-and-pop corner grocery stores; they felt that selling customers convenience in the form of accessible hours, handy locations, big parking lots, and well-selected merchandise would translate into a competitive edge and accelerate a shift of buyer patronage from the rapidly failing corner groceries to Southland's convenience food store concept. Southland's store expansion program began in earnest about 1960.

Southland's current business structure

5 In 1978, Southland's business interests were organized into three major groups. The Stores Group was the world's largest operator and franchiser of convenience stores with 6,599 7-Eleven stores in 42 states, the District of Columbia, and 5 provinces of Canada. Its three distribution centers served 3,916 7-Eleven stores with approximately 50 percent of their merchandise needs. Food Centers, located at each distribution center, prepared a variety of sandwiches for distribution to 7-Eleven and other customers. Other retail operations included 109 Gristede's and Charles & Company food stores and sandwich shops in metropolitan New York, 383 R. S. McColl confectionery, tobacco, and news stores, and 7 7-Eleven units in the United Kingdom. Southland also had an equity interest in 5 Super Siete stores in Mexico and 23 Naroppet stores in Sweden. An additional 279 7-Eleven stores were operated by area licensees in the United States, 559 in Japan, 5 in Canada, and 12 in Australia.

6 The Dairies Group, another part of the Southland Corporation, was a major processor of dairy products which were distributed under 11 well-known regional brand names in 34 states and the District of Columbia.

7 The Special Operations Group included the Chemical, Reddy Ice, Hudgins Truck Rental, and Tidel Systems which manufactured money handling devices for retail operations. In addition, Chief Auto Parts, a retail automobile supply chain of 119 stores in southern California, was added to the group in late 1978.

8 Exhibit 1 gives a breakout of the sales revenues and operating profits of

exhibit 1

Revenues and operating profits by major business segment ($ millions)

	1978		1977		1976		1975		1974	
Revenues:										
Stores Group	$2,791.0	90%	$2,271.9	89%	$1,857.5	88%	$1,556.0	87%	$1,405.4	87%
Dairies Group	253.4	8	236.5	9	236.1	11	208.3	12	184.0	11
Special Operations Group	40.9	2	33.7	2	26.0	1	25.0	1	22.6	2
Corporate	4.8	—	3.3	—	2.4	—	1.5	—	2.2	—
Total	3,090.1	100	2,545.4	100	2,122.0	100	1,790.8	100	1,614.2	100
Operating profits:										
Stores Group	142.7	92	115.7	90	92.3	86	80.8	88	68.5	85
Dairies Group	6.7	4	6.0	5	8.6	8	10.1	11	8.1	10
Special Operations Group	6.0	4	6.7	5	6.4	6	.9	1	4.0	5
Total	155.4	100	128.4	100	107.3	100	91.8	100	80.6	100

Source: Company records.

exhibit 2

Southland Corporation financial summary ($000)

	1978	*1977*	*1976*	*1975*	*1974*
Operations (Note 1):					
Total revenues	$3,090,094	$2,545,415	$2,122,023	$1,790,805	$1,614,188
Increase over prior year	21.40%	19.95%	18.50%	10.94%	15.47%
Net earnings	$57,097	$45,317	$37,849	$32,068	$27,167
Increase over prior year	25.99%	19.73%	18.03%	18.04%	25.85%
Per revenue dollar	1.85%	1.78%	1.78%	1.79%	1.68%
Return on beginning shareholders' equity	17.30%	15.62%	14.56%	13.72%	13.16%
Assets employed (Note 1):					
Working capital	$141,633	$136,693	$101,536	$80,196	$72,495
Current ratio	1.54	1.66	1.63	1.58	1.55
Property, plant, and equipment including capital leases (net)	$677,284	$567,442	$506,190	$447,392	$406,486
Depreciation and amortization	67,724	61,735	55,029	47,974	43,078
Total assets	1,134,476	942,531	799,261	696,107	639,599
Capitalization (Note 1):					
Long-term debt	$261,460	$195,520	$153,093	$119,911	$105,609
Capital lease obligations	*211,342*	192,547	178,556	163,380	155,918
Shareholders' equity	374,467	329,952	290,142	259,940	233,659
Total capitalization	847,269	718,019	621,791	543,231	495,186
Shareholders' equity to total capitalization	44.20%	45.95%	46.66%	47.85%	47.19%
Per share data (Notes 1 and 2):					
Primary earnings	$2.83	$2.26	$1.92	$1.63	$1.42
Earnings assuming full dilution	2.74	2.19	1.85	1.58	1.35
Cash dividends	.68	.55	.44	.36	.30
Shareholders' equity	$18.55	$16.48	$14.68	$13.23	$12.21

Other data:					
Cash dividends	$13,627	$10,961	$8,660	$7,033	$5,834
Dividends as a percent of earnings (Note 1)	23.87%	24.19%	22.88%	21.93%	21.47%
Stock dividends	3%	3%	3%	3%	3%
Average shares outstanding (Note 3)	20,181,879	20,015,512	19,761,788	19,642,947	19,137,414
Average diluted shares (Note 3)	21,129,981	21,028,143	20,911,047	20,883,719	20,854,737
Market price range (Note 3)					
High	$33¾	$25⅞	$26⅛	$26¼	$18⅞
Low	21½	19¼	19⅛	14	11⅜
Year-end	26¾	24⅝	25½	20⅜	14¼
Number of shareholders	8,627	8,764	8,881	9,093	9,351
Number of employees	37,000	34,000	31,000	28,600	28,200

Notes:

(1) The years 1974 through 1977 have been restated for the change in the method of accounting for leases to comply with the privisions of *Statement of Financial Accounting Standards No. 13* which was adopted early in accordance with the requirements of the Securities and Exchange Commission.

(2) Based on average shares outstanding adjusted for stock dividends.

(3) Adjusted for stock dividends.

Source: 1978 annual report.

these three groups. Exhibit 2 provides a corporate-wide financial summary, and Exhibit 3 is a condensed statement of consolidated earnings.

Customer profile of Southland's 7-Eleven stores

9 Approximately 5.4 million people patronized 7-Eleven stores daily in 1978. Based upon a study it conducted that year, Southland came up with a profile of its customers:

69.8 percent male
80.2 percent in 18–49 age group
80.9 percent live/work in area
4.3 average trips a week
30.1 percent shop weekends
50.2 percent shop 1 P.M. to 10 P.M.
$1.54 average purchase
822 customers daily per store

On the average, the typical customer spent less than $2—and three to four minutes—at the store, and often made at least one unplanned impulse

exhibit 3

THE SOUTHLAND CORPORATION
Consolidated Statement of Earnings
For the Years 1974–1978
($000 except per share data)

	1978	*1977*	*1976*	*1975*	*1974*
Revenues:					
Net sales	$3,076,532	$2,536,109	$2,115,769	$1,787,928	$1,609,257
Other income	13,562	9,306	6,254	2,877	4,931
Total revenues	3,090,094	2,545,415	2,122,023	1,790,805	1,614,188
Cost of sales and expenses:					
Cost of goods sold, including buying and occupancy expenses	2,311,024	1,903,791	1,577,141	1,323,799	1,184,835
Selling, general, and administrative expenses	619,519	510,337	435,687	374,234	348,797
Interest expense	15,804	13,540	9,707	7,936	8,674
Imputed interest expense on capital lease obligations	19,325	18,064	15,388	13,969	12,982
Contributions to employees savings and profit sharing plan	11,714	9,726	8,346	6,995	5,899
Total cost of sales and expenses	2,977,386	2,455,458	2,046,269	1,726,933	1,561,187
Earnings before income taxes	112,708	89,957	75,754	63,872	53,001
Income taxes	55,611	44,640	37,905	31,804	25,834
Net earnings	57,097	45,317	37,849	32,068	27,167
Per share					
Primary earnings	2.83	2.26	1.92	1.63	1.42
Earnings assuming full dilution	2.74	2.19	1.85	1.58	1.35

Source: 1978 annual report.

purchase. Through these small unplanned purchases did not amount to much extra expense for the individual customer, they resulted in significant extra sales and profits to Southland, given that over 5 million customers a day were involved.

10 According to a reporter for *The Wall Street Journal:*

> Southland's 7-Elevens are successors of the old-fashioned mom-and-pop grocery, but they prosper by catering to the modern urge for instant gratification. Their customers fill their pantries at the supermarket but dash instead to the closest 7-Eleven to fill their latest desire for, say, cigarettes or cold beer. Indeed, well over half the goods a 7-Eleven sells are consumed within 30 minutes. . . .[1]

The same article quoted a 7-Eleven customer who lived in Dallas:

> I usually stop by on the way to work to get a roll, in the afternoon to pick up a TV dinner, and sometimes during the day to get a coke. I'm a bachelor and it's quick and convenient.

This view reflected management's own perceptions that Southland was really in the convenience business rather than in the retail grocery business.

Store growth and locations

11 Southland's management looked upon convenience as "giving customers what they want, when they want it, where they want it." As a consequence, in 1978, 5,407 of Southland's 6,599 7-Elevens were open around the clock and 91 percent were open beyond the traditional 7 A.M. to 11 P.M. hours. Moreover, Southland emphasized easily accessible neighborhood locations and quick, friendly service; its product lines included popular fast-foods selections and, at 30 percent of its locations, self-service gasoline.

12 In recent years, Southland has opened about 500 new 7-Eleven stores per year. The net gain in stores has been smaller, however, because population shifts, changes in traffic patterns, lease expirations, and relocations to newly available and more desirable sites have resulted in some existing stores being closed. The number of store openings and closings since 1972 are shown in Exhibit 4.

13 Southland used a meticulous store site selection system; the primary criteria included such factors as (1) the traffic count in front of the site, (2) the ease with which passing cars could enter and leave the site, (3) the site's visibility from the street or road, (4) the number of people living within a one-mile radius, (5) the site's proximity to apartments, subdivisions, and high-traffic commercial establishments, (6) the adequacy of parking space, and (7) whether the site was a natural stopping-off point in the traffic flow by the site. To make sure its small 2,400-square-foot stores were readily seen from approaching traffic, they were carefully positioned in a heavy traffic

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[1] Gerald F. Seib, "Despite High Prices and Sparse Selection, 7-Eleven Stores Thrive," *The Wall Street Jounal,* May 1, 1979, p. 1.

exhibit 4

	New stores opened	*Existing stores closed*	*Total 7-Eleven stores*
1972	424	83	4,455
1973	426	80	4,801
1974	n.a.	n.a.	5,171
1975	566	158	5,579
1976	528	154	5,953
1977	658	254	6,357
1978	550	308	6,599

n.a. = Not available.

area where they could be seen easily and were convenient to passers-by. Traffic patterns and flows were so crucial that stores had failed because a street was made one-way or because the opening of new streets and subdivisions had shifted traffic away from a site. Southland extensively studied potential sites and used a computer to estimate a proposed store's sales for its first five years.

14 John Thompson, Southland chairman, recently indicated that when a store starts looking like a loser, "We would rather close then and take our licks." The poor performers were identified by computerized analysis; by merely punching the store number into a computer terminal, executives could call up on a terminal display the store's current sales and earnings and tell how close it was to its budget. The company's management kept a close check on each store's operating performance.

15 In 1977, Southland started opening central-city stores. Located in high-density metropolitan residential areas, Southland saw them as filling a genuine need for walking customers. The company now has central-city stores in Philadelphia, Boston, San Francisco, and New York City; more are planned. According to Thompson, the central-city stores "open up a whole new market area we haven't yet been able to serve. We will attempt to build and merchandise stores according to their neighborhoods."

Product lines and Merchandising

16 Southland continually experimented with the product mix offered in the stores. Some products, like the frozen concoction "Slurpee," became huge successes. Others, like 7-Eleven beer, turned out to be quiet flops.

17 One Southland executive stated, "There's little risk involved in experimenting. We have a built-in market base of 5 million customers a day. Things that don't work out we can throw out after a week or two. Things that catch on in one store we can try nationwide. Our computers in Dallas can tell us overnight about any new market trends."[2] 7-Eleven stores carried 3,000

[2] "7-Eleven Creates a Mood of Convenience at a Price," *The Washington Star,* November 27, 1978.

different items, about 23 percent of them Southland's own house brands. The larger percentage of brands available in a 7-Eleven store were nationally recognized brands; however, each item was located in a space predetermined by a Southland computer in Dallas. One Southland executive indicated:

> There is no room to store a lot of different brands of the same product. Our customers don't have time to make choices anyway. We usually put on our shelves only the top one or two sellers of every product line and we put them in the area of the store where we think the customer would like to find them. It's all been researched and market tested. I can walk into most stores blindfolded and find any item you want.[3]

18 Through 1977, Southland's biggest selling item was tobacco—cigarettes primarily—followed closely by groceries, beer and wine, soft drinks, nonfood items such as magazines and Kleenex, and dairy products (see Exhibit 5). However, tobacco products dropped from number one in 1978, the change primarily due to increased gasoline sales. 7-Elevens have at times sold shotgun shells, television tubes, watermelons, and cancer insurance. Among the stores' best selling items today are fast-food sandwiches, disposable diapers, and *Playboy* magazines (of which 7-Elevens sell far more than any other retailer). In general, the items carried were products that would be needed on a fill-in basis or else bought on impulse.

exhibit 5

7-Eleven store sales by principal product category*

	1978	*1977*	*1976*	*1975*	*1974*
Groceries	13.4%	14.0%	14.6%	15.3%	17.1%
Gasoline	13.4	9.8	6.8	3.9	2.7
Tobacco products	12.9	14.2	14.7	15.6	15.7
Beer/wine	12.9	13.7	14.4	14.8	14.1
Soft drinks	10.9	11.0	10.7	11.5	11.5
Nonfoods	9.4	9.9	10.2	9.5	9.3
Dairy products	8.9	9.3	9.6	9.5	10.5
Other food items	5.5	4.7	4.7	4.2	3.9
Candy	4.7	5.0	5.4	5.7	5.3
Baked goods	4.6	5.0	5.3	5.7	5.9
Health/beauty aids	3.4	3.4	3.6	3.9	4.0
Total	100.0%	100.0%	100.0%	100.0%	100.0%

*The company does not record sales by product lines but estimates the percentage of convenience store sales by principal product category based upon total store purchases.
Source: 1978 annual report.

19 By the end of 1978, self-service gasoline accounted for 60 percent of all gasoline sales in the United States and showed every indication of increasing beyond that figure, according to industry sources. In response to this demand, 7-Eleven provided self-service gasoline at 1,857 locations. A substantial increase in volume at existing units, as well as the addition of gasoline at

[3] Ibid.

284 stores during 1978, resulted in a 70 percent gasoline sales increase for the year. The availability of gasoline also led to the generation of additional sales, as more than 30 percent of 7-Eleven's gasoline customers in 1978 purchased other merchandise.

20 One merchandising trend of particular import was that of adding higher-margin items to each store's product line to try to boost store profitability. Fast-food items like sandwiches, pizza, soup, coffee, fruit punch, and draft soda (like Slurpee) carried gross margins in the 40 percent range. Nonfood impulse items, which had margins in the 35 percent range, were also being added. Both compared favorably with Southland's recent storewide margins of 25 percent to 27 percent. Southland's fast-food division, which in 1978 experienced a 30.5 percent sales gain, produced approximately 30 sandwiches marketed under the 7-Eleven and Landshire labels. These were distributed either fresh or flash-frozen for reheating in microwave or infrared ovens. The division in 1978 sold approximately 80 million sandwiches to 7-Eleven stores, other retailers, and institutional customers; it also furnished 7-Eleven stores with more than 1 million gallons of Slurpee syrup.

21 Southland's management was optimistic about the potential for increasing its share of the food-away-from-home market. Projections called for this segment to increase its share of the consumer's total food dollar owing to greater numbers of women entering the work force, higher family incomes, smaller families, and more single people—all of which acted to reinforce the lifestyle where a higher percent of disposable personal income would be spent for food prepared outside the home.

Pricing

22 According to Southland's marketing research director, people just about everywhere are willing to pay a little extra for the convenience a 7-Eleven offers—especially when the consumer is hit by an urge to buy. Most of the items in a 7-Eleven are therefore priced some 10 to 15 percent above the levels in most supermarkets. But, as shown in Exhibit 6, a few items, like milk, are priced more competitively.

23 As one 7-Eleven customer put it:

> There's a lot I don't like about 7-Eleven stores. They look tacky. They charge too much. They sell stuff that isn't good for you, and they always seem to be getting robbed. But yes, I do shop there. They're so convenient.[4]

So far, though, no consumer activist groups had targeted 7-Eleven for either its high prices or its line of merchandise.

24 Southland seemed to have discovered, and was helping perpetuate, its own market segment—a world of customers caught in a time crisis, willing

[4] "Southland is the Best Example I Know of Modern Capitalism," *The Washington Star*, November 26, 1978.

exhibit 6

Sample comparisons of prices at 7-Eleven stores and Safeway supermarkets in 1978

Item	*7-Eleven*	*Safeway*
Cascade (20 oz.)	$ .98	$ .89
Shredded wheat (12 oz.)	.93	.75
Tuna (chunk light, 6 oz.)	1.19	.99
Campbell's chicken noodle soup	.36	.30
Jello instant pudding (4 oz.)	.40	.35
Log Cabin maple syrup (12 oz.)	1.15	.93
Hellman's mayonnaise (16 oz.)	1.23	.99
Franco-American spaghetti (14 oz.)	.39	.34
Domino sugar (5 lbs.)	1.59	1.49
Wesson oil (16 oz.)	1.19	.99
V-8 juice (46 oz.)	1.09	.85
Maxwell House instant coffee (6 oz.)	4.29	3.79
Kellogg's corn flakes (12 oz.)	.85	.69
Hydroz cream-filled cookies	1.19	1.09
6-pack of Budweiser (12 oz.)	2.33	1.99
6-pack of Schlitz Light	2.34	1.99
Gallo burgundy wine	2.23	1.99
6-pack of Pepsi (16 oz.)	2.02	1.89
7-up (32 oz.)	.71	.63
Hostess cup cakes (2)	.35	.33
White bread (22 oz.)	.73	.40
Hostess powdered doughnuts (12)	.99	.99
Dozen eggs (grade A large)	.89	.79
Minute Maid orange juice (quart bottle)	.85	.75
Philadelphia cream cheese (3 oz.)	.43	.34
Salt (26 oz.)	.35	.30
Bayer aspirin (50 tablets)	1.19	.89
Heinz ketchup (14 oz.)	.79	.61
French's mustard (9 oz.)	.55	.43
Carton of Winston cigarettes	4.79	4.49
10 Briggs hot dogs	1.69	1.39
Half-gallon milk	.91	.91
Total (32 items)	$40.97	$35.55

Source: *The Washington Star,* November 26, 1978.

to pay extra to save themselves a few seconds waiting in line. A Wall Street analyst said:

> It is perplexing to us why Southland's revenue growth has accelerated when rising prices have stretched the consumer's budget to a considerable extent. Perhaps it is time rather than money which is the precious commodity to most Americans at present. The appeal of convenience stores has nothing to do with price. It has to do with people's lifestyles and their constant need for fill-ins. The more tightly the pocketbook is pinched, the less frequently the housewife shops at her supermarket, and the more need she has for last minute fill-ins.[5]

[5] "7-Eleven Creates a Mood of Convenience."

Franchise activities

25 Of the 6,599 7-Eleven stores operating at the end of 1978, 4,056 were company operated and 2,543 were franchised. The typical franchise agreement allowed for the company to lease the property and equipment to a franchisee in exchange for a fee of $10,000 plus roughly half the store's profits. Southland allowed new franchises a 120-day grace period to pull out of their contracts without losing their initial investments. Most of the franchisees were couples with children and the family typically worked in the store.

Southland's advertising for 7-Elevens

26 In January 1978, Southland introduced its first prime-time network 7-Eleven commercial to the largest audience in television history prior to Super Bowl XII. Product awareness messages featuring Hot-to-Go coffee, Egg Hamlette, Chili Dog, Slurpee, or sunglasses reached 58 million households each broadcast week. In addition to the network television commercials, advertisements were aired on approximately 500 radio stations and published in more than 200 newspapers nationwide.

27 During 1978, broadcasts remained the company's major advertising vehicle with spot radio getting 30 percent, network television 35 percent, spot television 25 percent, newspapers 4 percent, and outdoor advertising 6 percent. Total television advertising increased 22 percent during the first half of 1978, compared with the same period in 1977.

28 7-Eleven stores are decidedly male oriented. However, due to the increased buying power of women in today's society, Southland's advertising had begun to be geared specifically toward women.

Distribution centers

29 Southland's 7-Eleven stores were served by distribution centers in Florida, Virginia, and Texas that were specifically designed to meet the needs of 7-Eleven for a reliable and efficient source of supply, frequent delivery, and a high in-stock position. The system also enabled the stores to have the flexibility to respond quickly to customer preferences and seasonal changes in demand, as well as to implement promotional programs and introduce new products. The centers serviced 3,916 7-Eleven stores at the end of 1978.

30 Store stock lists, which are compiled and updated monthly by computer, were tailored to the merchandise specifications of each store, enabling personnel to easily determine their restocking needs. The store orders were then transmitted through a network of computer terminals located at 7-Eleven district offices and connected to the computer center in Dallas, which assimilated the orders and transmitted them to printing terminals at the appropriate distribution center. From these printed lists, the store orders were then picked and assembled for delivery. Custom-designed trucks with

separate compartments for dry, chilled, and frozen merchandise followed computer-planned routes to achieve maximum savings of energy and time.

31 Southland's concept of delivering prepriced merchandise in less-than-case-quantities eliminated overstocking, assured fresh merchandise on the store shelves at all times, promoted more productive use of selling space, and improved store profitability. The importance of stores not having to order full cases of merchandise was highlighted by Southland's manager of information services: "Can you imagine how long it would take to sell 48 cans of tomato paste in a 7-Eleven? Now we can give them three cans and keep it fresh." During 1978, the computerized inventory control system enabled the stores to achieve an average inventory turnover of 23 times while maintaining a 99 percent order fill rate.

32 In many cases, store managers did not even bother to order groceries; that was done by warehouse employees whose only job was visiting each 7-Eleven twice a month to take inventory and order merchandise.[6] The computer then took over, sending hundreds of orders to a warehouse, deciding which orders to ship on what truck, and telling employees how to stack goods inside the truck to fill it to the brim. The trucks were able to begin delivering only hours after the warehouse got the order. Southland's computer also helped analyze the layout of merchandise in the store—by keeping track of what items sold well in which shelf locations.

Financing

33 The long-term policy of Southland was to finance expansion from retained earnings, although other methods of raising funds were used when necessary. In late 1978, the company offered $50 million of unsecured 9⅜ percent sinking fund debentures, due December 15, 2003. These debentures, as well as a 1977 8⅜ percent issue, were rated A by both Moody's and Standard & Poor's and were listed on the New York Stock Exchange.

34 In April 1978, the annual cash dividend rate was increased 20 percent to 72 cents per share. Cash dividends have been paid each year since 1957, and the annual rate has been raised seven times in the last eight years, providing shareholders an average compound growth rate of 20.7 percent. In addition, for the 13th consecutive year, a 3 percent stock dividend was distributed.

35 In recent years, Southland has been forced to increase its debt burden to finance corporate expansion—especially the growth in the number of 7-Eleven stores. To open a new store, Southland had to invest more than $180,000. This included land costs of about $50,000, a store building costing an average of $70,000, equipment installation of $46,000, and initial inventory costs of $18,000 to $25,000. In the case of franchised stores, Southland advanced most of the up-front investment, with the exception of the $10,000 franchise fee.

[6] Seib, "Despite High Prices."

36 The capital costs of financing 400–500 new stores per year had exceeded Southland's retained earnings and internal cash flow capabilities during recent years; the resulting debt increases were in such an amount as to cause a steady decline in Southland's equity capitalization percentage (see Exhibit 2).

37 Although a 41-year-old Southland official expressed the view that the company would be adding a net of 300–400 stores per year for the rest of his lifetime, it was not clear that Southland could continue to finance such an ambitious store expansion program without adversely affecting earnings. Higher site and construction costs and higher interest rates were becoming significant factors; so was the move to increase store size from 2,400 square feet to the 2,700 to 3,000 square feet range. In 1977, Southland spent an estimated $75.3 million to open 658 stores; in 1978, the figure exceeded $95 million for 550 new stores.

38 Nor was it clear that such a rate of expansion was consistent with market opportunities. Already there were over 33,000 convenience food stores in the United States—approximately one for every 6,600 persons. Prime sites were becoming hard to find and were increasingly expensive. According to one industry trade publication, several factors were at work:

> Munford executives, like most in the business, have set their sights on prime corner locations with high visibility and heavy traffic counts. Because Munford is selecting former gas station sites for its new units, traffic counts have replaced household density, once the sacred cow of the industry's site selection procedure.
>
> In fact, one Majik Market is making $7,000 per week in food sales—the industry average is $5,257—without a house within a five-mile radius of the store.
>
> Secondary sites, mainly at the mouths of suburban subdivisions and in shopping malls, are a thing of the past. "The suburban, residential convenience store is doomed," explained Tom Ewens, vice president of real estate for Houston-based National Convenience Stores Inc., "because the sales volume that those units produce simply can't keep pace with the costs of land, construction, and operation."
>
> But the recently sought-after, first-rate corner spots are getting harder for convenience store chains to find due, in part, to increased competition from other retailers for the same locations. As store sizes creep up to the 3,000-square-foot mark, and lot sizes expand to allow for increased gas and parking facilities, convenience stores are looking for roughly the same size lot that a fast-food unit, drugstore, bank, or gas station might want. This means that the sector's traditional strength of flexibility in site selection is being somewhat impaired.
>
> And in some markets, notably parts of Arizona, Texas, and Florida, where convenience stores already account for 10 percent–12 percent of grocery sales, there just aren't that many choice spots to be found.
>
> John C. Nichols II, senior vice president and chief financial officer of Convenient Industries of America Inc., reveals that the Louisville, Kentucky-based operator of Convenient Food Marts is having to look at more

sites today than in the past to find good ones, like its industry counterparts. Three years ago a site might have been selected from two or three. Now it's more likely that seven or eight are considered before a choice is made.

What's happening is that convenience stores are pinning their hopes for higher sales volumes and profits on primary locations, while coping with higher real estate and operations costs than they faced at former sites.

This means that convenience stores' profit and loss statements will likely get tighter and tighter, the line between a winning and losing location more thinly drawn.[7]

Exhibits 7 and 8 contain additional financial data on Southland.

exhibit 7

SOUTHLAND CORPORATION
Consolidated Balance Sheets
For the Years Ended December 31, 1977 and 1978

Assets	*1978*	*1977*
Current assets:		
Cash and short-term investments	$ 82,745,504	$ 65,903,801
Accounts and notes receivable	78,968,103	75,171,378
Inventories	161,254,967	126,913,578
Deposits and prepaid expenses	26,777,392	21,436,624
Investment in properties	55,857,419	53,319,492
Total current assets	405,603,385	342,744,873
Investments in affiliates	27,364,352	26,717,136
Property, plant, and equipment	479,554,364	389,251,583
Capital leases	197,730,040	178,190,671
Other assets	24,223,652	5,627,054
Total assets	$1,134,475,793	$942,531,317
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 211,920,848	$168,894,391
Income taxes	18,636,987	15,481,417
Long-term debt due within one year	13,254,868	4,142,055
Capital lease obligations due within one year	20,157,217	17,533,856
Total current liabilities	263,969,920	206,051,719
Deferred credits	23,235,908	18,460,424
Long-term debt	261,460,472	195,520,000
Capital lease obligations	211,342,074	192,546,677
Committments for operating leases	—	—
Shareholders' equity:		
Common stock $1 par value, authorized 40 million shares, issued and outstanding 20,200,557 and 19,557,287 shares	202,006	195,573
Additional capital	242,339,882	223,499,443
Retained earnings	131,925,591	106,257,781
Total shareholders' equity	374,467,419	329,952,497
Total liabilities and shareholders' equity	$1,134,475,793	$942,531,317

Source: 1978 annual report.

[7] "What's Down the Road for Convenience Stores," *Chain Store Age Executive*, June 1979, pp. 23–24.

exhibit 8

SOUTHLAND CORPORATION
Consolidated Statements of Changes in Financial Position
For the Years ended December 31, 1978 and 1977

	1978	*1977*
Sources of working capital:		
From operations:		
Net earnings	$ 57,097,109	$ 45,317,241
Expenses charged to earnings which did not require outlay of working capital:		
Depreciation and amortization	46,839,875	41,991,861
Amortization of capital leases	20,884,330	19,743,097
Deferred income taxes and other credits	6,552,597	3,415,874
Working capital provided from operations	131,373,911	110,468,073
Long-term debt	70,658,506	61,534,160
Capital lease obligations	41,907,748	37,409,857
Retirements and sales of property	13,555,200	12,774,857
Retirements and sales of capital leases	1,397,049	6,191,948
Issuance of common stock		
Conversion of notes	—	2,690,000
Acquisitions	—	2,310,000
Key employees incentive plan	470,992	462,278
Employee stock options	704,463	97,343
Total sources of working capital	$260,067,869	$233,938,516
Uses of working capital:		
Property, plant, and equipment	$141,438,084	$ 96,324,184
Capital leases	41,907,748	37,409,857
Reduction of capital lease obligations	23,112,351	23,419,196
Payment of long-term debt	4,718,034	16,862,491
Cash dividends	13,627,443	10,960,976
Net noncurrent assets of businesses purchased for stock and cash	29,180,394	9,111,552
Retirement of long-term debt upon conversion of notes	—	2,690,000
Investments in affiliates	647,216	1,061,359
Other	366,089	836,640
Cash paid in lieu of fractional shares on stock dividend	130,199	105,267
Total uses of working capital	$255,127,558	$198,781,522
Increase in working capital	$ 4,940,311	$ 35,156,994
Changes in working capital:		
Increases in current assets:		
Cash and short-term investments	$ 16,841,703	$ 39,504,544
Accounts and notes receivable	3,796,725	7,788,618
Inventories	34,341,389	21,884,637
Deposits and prepaid expenses	5,340,768	1,482,830
Investment in properties	2,537,927	9,342,429
Total changes in working capital	62,858,512	80,003,058
Increases (decreases) in current liabilities:		
Accounts payable and accrued expenses	43,026,457	38,624,253
Income taxes	3,155,570	4,442,417
Long-term debt due within one year	9,112,813	(611,614)
Capital lease obligations due within one year	2,623,361	2,391,008
Total increases in current liabilities	57,918,201	44,846,064
Increase in working capital	$ 4,940,311	$ 35,156,994

Source: 1978 annual report.

Recent trends in the convenience food industry

39 In 1957, the industry consisted of 500 stores with an annual volume of $75 million. Ten years later, there were 8,000 convenience stores with combined sales of $1.3 billion. In 1978, the corresponding figures were some 33,000 stores and an annual sales volume of $8.7 billion. Average annual sales growth during the last five years was about 17 percent. Sales volumes in convenience food stores were approaching 5 percent of total U.S. grocery sales, up from 1.7 percent in 1967. Many industry sources predicted favorable sales growth for convenience food stores for the years ahead. Sales revenues were projected to increase at a 15 percent annual rate and volume was expected to reach 8 percent of total grocery sales by 1980.

40 For the extra convenience and service they offered, convenience food stores took higher markups on the items they sold. Whereas conventional supermarkets had an average gross margin of 22.4 percent in 1978, the gross margins in convenience food stores were typically 28 to 30 percent. Exhibit 9 gives a breakdown of the 1976 gross margin, expenses, and net profits for the representative convenience food store.

exhibit 9

Breakdown of 1976 margins, expenses, and net profit for the representative convenience store*

Sales	100.0%
Cost of goods sold	71.2
Gross margin	28.8
Employee wages	10.6
Employee benefits	1.9
Advertising and promotion	0.7
Property rentals	3.3
Utility expenses	3.2
Other expenses	5.7
Total expenses	25.4
Net profit before taxes	3.4

*Determined by trade sources from industry-wide data.

Source: *Convenience Stores*, September–October 1977, p. 44.

41 Recently, industry observers had become concerned with the increased competition that supermarkets seemed to be initiating. Specifically, the trends of many supermarkets toward longer hours, Sunday openings, and express-lane checkouts had the potential of eroding the market shares of convenience food stores. In response, some convenience chains were keeping prices on selected high volume items as close to those of supermarkets as possible. Munford's Majik Market stores, Southland's biggest competitor, recently adjusted the prices of some 25 of its best-selling items to be competitive with supermarket prices.

42 In addition to competition from supermarkets, competition from other

retail sectors was emerging. Fast-food chains, liquor-delis, gas stations carrying food items, and discount and drug outlets with newly added food items were a new competitive threat. These types of firms were expected to expand their convenience food lines and to begin to carry high-traffic nonfood items. Furthermore, many of the drugstores were staying open longer hours and opting for locations with many of the same features of convenience stores.

7-Eleven's competitors in convenience foods

43 7-Eleven in 1978 was more than seven times the size of Munford, its nearest competitor. (Munford is the only other convenience chain listed on the New York Stock Exchange.) In recent years, while 7-Eleven had been booming, Munford had been having more than its share of problems. While in the process of closing marginal and unprofitable units, earnings and sales for Munford suffered accordingly. In addition to their stores group, Munford experienced problems with Farmbest Foods, a dairy operation acquired in 1975. The Farmbest operation lost money in 1977 due to unsettled industry conditions in Florida and Alabama.

44 A new merchandising concept being tried by Munford, in order to catch up with the industry, was to join forces with major oil companies such as Texaco, Gulf, and Amoco by putting Munford's Majik Market convenience stores at existing gasoline station sites. The executives of Munford felt that there were many advantages for this concept, because they were convinced that the consumers were accepting the idea of buying gasoline at convenience stores very well.

45 Another competitive factor in the convenience store field was Circle K. For a period of four years through 1977, Circle K virtually halted its store expansion program in favor of remodeling and renovating older, existing stores. The Circle K chain, like Munford and others, entered the gasoline business, but with a basic difference from Munford, Circle K's strategy was to retain its recognition and image as convenience first and gasoline second. For this reason, Circle K chose to add gasoline pumps to their existing stores, not vice versa, as Munford did. Circle K planned to add 60 to 70 stores a year through the mid-1980s.

46 A third competitor of 7-Eleven was the National Convenience stores chain. In 1976, a young, dynamic man named Pete Van Horn became president of National Convenience. Not being fettered by the bonds of tradition in the industry, Van Horn slashed the number of stores, lowered personnel turnover, increased sales in remaining stores and, in general, put National Convenience on a sound footing. Van Horn was anxious to try out his ideas about store layout, merchandising, and expansion; his goal at the end of 1977 was to double earnings in the next four years.[8]

[8] "The Convenience Stores," *Financial World,* November 1, 1977.

exhibit 10
Sales and earnings of convenience chains

	Sales ($000)			Earnings ($000)		
Company	*1978*	*1977*	*1976*	*1978*	*1977*	*1976*
Southland	$3,089,000	$2,544,414	$2,121,146	$57,000	$45,348	$40,277
Munford	378,950*	340,174	334,770	6,090	(770)	3,427
Circle K	363,783	302,603	262,362	8,196	6,912	5,122
National Convenience stores	263,705	233,208	212,606	5,011	3,536	2,652
Utotem group	221,423	206,041	192,499	9,658	8,788	8,822
Convenient Industries of America	177,732	146,598	123,368	1,148	896	857
Sunshine-Jr. stores	93,553	81,225	68,899	1,622	1,432	1,387
Shop & Go	82,729	70,136	60,780	2,271	1,655	1,650
Hop-In food stores	31,714	22,739	14,077	658	392	280
Lil' Champ	22,727	21,006	18,807	778	647	592
Grand total	$4,725,316	$3,968,144	$3,409,314	$92,432	$68,836	$65,066

Note: Includes sales and earnings from operations other than convenience stores where applicable.
*Estimated.
Source: *Progressive Grocer*, April 1978.

47 Exhibit 10 presents comparative sales and earnings for 10 leading convenience food chains. Exhibit 11 contains per store sales and profit statistics for the 1974–1978 period.

exhibit 11
Average sales and profit statistics for top 10 publicly held convenience food store chains

	1978	*1977*	*1976*	*1975*	*1974*
Yearly sales per store	$274,115	$263,895	$240,828	$232,140	$213,800
Weekly sales per store	$5,257	$5,061	$4,606	$4,452	$4,110
Profit on pretax sales	3.65%	3.48%	3.64%	3.32%	3.39%
Profit on aftertax sales	1.98%	1.8%	1.92%	1.71%	1.77%
Yearly pretax profit per store	$10,026	$9,194	$8,762	$7,723	$7,240
Yearly aftertax profit per store	$5,431	$4,752	$4,523	$3,978	$3,780

Source: "Eighth Annual Dollars-per-Day Survey of Small Food Store Industry," as published in *Chain Store Age Executive*, June 1979, p. 26.

Southland's Dairies and Special Operations groups

48 Initially, the Dairies and Special Operations groups were formed to vertically integrate their activities with 7-Eleven. The Dairies group processed and distributed milk, ice cream, yogurt, juices, eggnog, dips, and toppings; in 1978, it served 5,295 of Southland's convenience stores and supplied 66 percent of all the dairy products sold in all 7-Eleven stores. The group includes 28 processing plants and 86 distribution locations. However, more and more of the Dairies group sales volume was coming from outside Southland. In 1978, 65 percent of the unit's $400 million sales revenues were to

food retailers such as Denny's and Wendy's. The expansion of sales to outside companies was being pursued through the development of new high-margin novelty items such as sundae-style yogurts, cheeses, and frozen dairy items like Big Deal, Gram Daddy, and Big Wheel.

49 A similar trend was evident in the Special Operations group. While this division supplied other Southland units with food ingredients, ice, Slurpee concentrate, preservatives, sanitizers, and cleaning agents, in 1978 a total of 72 percent of sales were to outside customers. In 1978, the chemicals unit was expanded by the acquisition of a New Jersey fine chemicals plant; this acquisition allowed Southland to market a broader line of products to customers in the agricultural and pharmaceutical industries. The division's Hudgins Truck Rental unit was expanding its efforts to provide full-maintenance truck leasing to national and regional customers, as well as to Southland operations; in 1978, its outside sales were up 10 percent and accounted for 68 percent of revenues. In 1978, a new unit called Tidel Systems was added to the Special Operations group; it manufactured an innovative money-handling device designed to reduce losses from robberies and to increase store-site cash handling efficiency. While Southland planned to install the device at its 7-Eleven stores, there was an even greater potential for sales to other retailers and a nationwide sales and maintenance organization was being assembled.

The acquisition of Chief Auto Parts

50 In December 1978, at a cost of $20 million, Southland acquired the assets of Chief Auto Parts, a chain of 119 retail automobile supply stores in southern California. A typical Chief store was 2,000 square feet in size, open seven days a week, and located in a neighborhood shopping center close to homes or businesses. The stores sold approximately 7,500 replacement parts and accessories and carried both national brands and private-label products. The average purchase was $5 and a large percentage of sales were on weekends when most do-it-yourselfers had time to service their cars. Chief also had a modern warehouse in Los Angeles from which it supplied its stores.

51 There was some thought that the Chief acquisition signaled a move by Southland to diversify into small store retailing, particularly those kinds of retail businesses which had operating characteristics similar to those of 7-Eleven stores.

Future outlook

52 Southland management's view of the future for its 7-Eleven stores was exemplified by John Thompson, chairman:

> We believe that the growth opportunity in the convenience store area is great. I'm very bullish on the future. There are many parts in the United

> States that are not saturated with convenience stores, and I would say that Texas and Florida are the two most saturated areas. Even in those states we can go 20 to 40 more stores a year, depending on housing. But in the rest of the United States, there is relatively much less saturation, so that as far as we're concerned we think we can build 500-plus stores a year for a long time. Why, the Northeast is a great area. We haven't really saturated that market at all. And the Midwest? Well, we've hardly gotten started there. And California? Well sure we have 900 stores in California, but you can build forever in that state, I guess you could say the future for us looks marvelous.[9]

However, in 1979, several industry observers were taking a more cautious stance and asking if the industry was not on the verge of maturity.

[9] "Southland Is the Best Example."

case 15

Coca-Cola Wine Spectrum (A)

1 Albert Killeen, general manager of Coca-Cola's newly formed Wine Spectrum division, was concerned about mounting delays in a "revolutionary" comparative advertising campaign for Taylor California Cellars wines. Not only was this the first major campaign of the Wine Spectrum division involving the California Cellars winery, the Taylor name, and bottling by Coca-Cola of New York's Franzia subsidiary, but issues had also arisen over the legality of comparative taste tests for wines. After three months of discussions with lawyers and federal officials, Killeen had still been unable to get a ruling. Basically, it all boiled down to: "Do we wait for, probably, another year or go ahead and risk legal actions?"

2 Prior to the 1977 acquisition of Taylor Wine Company by Coca-Cola, Inc., Taylor management had promoted the concept that wine was right for any time and any place in "Taylor territory." They had also worked to educate consumers to appreciate New York wines by using the "answer grape." Since California wines were blended into Taylor products, a later campaign used the term "Californewyork" to try to broaden the appeal of Taylor wines. However, Taylor's marketing organization had never seen wine commercials quite like the introductory campaign proposed by their new advertising agency (see Exhibit 1). The new ads were based on a comparative taste test which not only named Taylor California Cellars as the best, but named the competing wines.

3 The problem with the new ad campaign was that of determining whether comparative advertising of wine was allowed under federal regulations. The federal Bureau of Alcohol, Tobacco, and Firearms (BATF) had regulatory powers over the industry's advertising, but officials had refused to give any determination. The courts had also refused to hear the case prior to action being taken by Taylor. BATF was reviewing its regulations on the wine industry but contended that only after running the ads would competitors bring forward the evidence necessary for them to make their judgment. BATF would not protect Coca-Cola or Taylor from legal consequences should they be found in noncompliance with regulations. While it was generally known that misleading or disparaging ads were not permitted, specific guidelines on comparative taste tests in wines were not expected for another year.

This case was prepared by William R. Boulton of the University of Georgia and Phyllis G. Holland of Georgia State University.

exhibit 1
Comparative taste test advertisement script

Program:	"San Francisco Wine Test"	**Client:** Taylor Wine Company
	Video	*Audio*
Open on:	Taster (male) inspecting glass and sniffing	**Announcer V/O:** a new California Rhine wine is judged against its competitors. Twenty-seven wine experts gather in San Francisco
Cut to:	Master shot	
Title:	July 22, 1978	
Cut to:	Taster (male) sniffing	to compare four
Titles:	A-C. K. Mondavi Rhine B-Taylor California Cellars Rhine C-Almaden Mountain Rhine D-Inglenook Navalle Rhine	
Cut to:	Taster (male) sniffing	California Rhine wines.
Cut to:	Four glasses and handwriting	Which was judged best?
Cut to:	Tasters in foreground, Judge and Nationwide Consumer Testing Institute representatives in background	"Ladies and gentlemen, the wine you have judged best is
Titles:	A, C, and D out Remaining: B. Taylor California Cellars Rhine	Wine B."
Cut to:	Four glasses. Hand places Taylor bottle in front	**Ann'r V/O:** Wine B. New Taylor California Cellars Rhine
Title:	Out	Taylor California Cellars
Title:	Taylor label	
Cut to:	Glass A	
Title:	C. K. Mondavi Rhine	**Ann'r V/O:** Judged better than C. K. Mondavi
Pan to:	Glass C	
Title:	Almaden Mountain Rhine	Better than Almaden
Pan to:	Glass D	
Title:	Inglenook Navalle Rhine	Better than Inglenook
Cut to:	Taylor label	**Taster (male) V/O:** "An interesting wine.
Title:		**Ann'r V/O:** But when you cost a little more, you better be better.

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The wine industry in the United States

4 In 1972, wine prices were rising dramatically and there was great interest in entering the industry. New wine grape acreage soared, with more new acreage planted in 1971, 1972, and 1973 than the total of all previous plantings. In addition, speculators observed that foreign wines selling for $25 per case in the 1950s were selling for $500 to $1,000 per case and began to put bottles in storage. The 1972 vintage was bad and did not sell well, and the 1973 harvest was the largest in history. The increased supply led to a decline in prices which accelerated when the speculators put the hoarded wine on the market. By the time the first wine from the new plantings hit the market in 1974, inventories were at an all-time high and the oversupply was further increased

by another large harvest in 1975. In 1972, the average return to a California grower per ton of grapes crushed was \$217. In 1974 the return dropped to \$131 and to \$100 in 1975.[1]

5 By 1976 conditions were improving. Inventories were slowly being worked off and more grape vines were taken up than planted. Even though prices began to rise, producers were still cautious. In describing the future direction of the market, Taylor management indicated in 1976:

> In general, 1974 and 1975 were characterized by large grape harvests throughout the United States. It is believed that adverse weather conditions caused a smaller crop in 1976. However, increased grape harvests in the future may be anticipated as a result of substantial grape acreage which was planted in 1971 through 1974 and should mature approximately four years after planting. Grapes are a commodity which will continue to be affected by weather conditions, diseases, and grower practices, which cause uncertainty for the crop until each annual harvest is near. Despite increases in many production costs, the abundance of grapes and large wine inventories have generally restricted wine price increases on an industry-wide basis. Furthermore, as discretionary income is believed to impact directly on wine consumption, recent economic conditions have contributed to relatively level industry sales.

Wine consumption in the United States

6 Wine consumption in the United States was increasing both in absolute amounts and per capita. In 1977, 6 percent more wine entered distribution channels than in 1976 and the same advance was predicted for 1978. Wine consumption was 400 million gallons in 1977 or 1.85 gallons per capita, as compared to 1.7 gallons in 1976:

> Wine sales in the foreseeable future should grow 8 percent a year, versus less than 3 percent for distilled spirits, according to Marvin Shanken, editor of *Impact,* a widely respected liquor industry newsletter (soft-drink sales are growing 7 percent annually). By 1980, says Shanken, wines will overtake distilled spirits in gallons.[2]

7 Per capita consumption in the United States varied geographically, with the highest consuming states being on the east and west coasts. Highest per capita consumption was 5.41 gallons in Washington, D.C.—a far cry, though, from the Italian average of 26 gallons or the French average of 24. Twenty-two percent of the wine sold in the United States was sold in California, 10.6 percent in New York, 5.1 percent in Illinois, followed by New Jersey with 4.5 percent and Florida with 4.3 percent.

8 Wine consumption was greatest in the 21–40 age group (which was grow-

---

[1] Gigi Mahon, "Everything's Coming Up Rosés," *Barron's,* June 7, 1976, pp. 11-16.

[2] "Beverages: Basic Analysis," *Standard & Poor's Industry Surveys,* October 19, 1978, p. B-71.

ing as a percentage of the population) and was also greater among the more affluent income groups. Factors underlying increased wine consumption were said to be a growing preference for lighter, drier beverages; the availability of broadcast media to efficiently create a nationwide market, and growing purchases by women. A *Forbes* article stated that wine is

> increasingly purchased by women right along with the groceries. According to *Progressive Grocer,* the trade publication, 35 percent of all wine is sold in supermarkets. In addition more wine (particularly dry white wine) is now being sipped before dinner—as a fashionable substitute for the Martini and Bloody Mary.[3]

Wine production in the United States

9 In 1976 Taylor management noted several facts about U.S. wine production:

> California is the largest wine producing area in the United States, with New York State being the second largest producing area. Based upon the latest available industry estimates, California production increased 47 percent from 239.6 million gallons in 1969 to 351.9 million gallons in 1975. During this same period, wine production in New York increased approximately 32 percent from 26.3 million gallons to 34.7 million gallons. Based upon the most recent industry estimates, during 1975, 84 percent of U.S. wine produced (but not necessarily sold) was produced in California and 8 percent in New York. Taylor and many other non-California wine producers use California wines for blending purposes to achieve certain flavor characteristics.

10 In 1977 there were 615 wineries in 30 states, an increase of 41 percent from 435 in 1970. California had the largest number with 353, followed by New York with 39. Ohio, Oregon, Michigan, and Pennsylvania each had 16. Average production was 20,000 gallons per year as compared to Gallo's production of 100 million gallons annually. Many of the smaller wineries were still waiting for their first vintage. Exhibit 2 shows the ownership of major brands in the wine industry.

11 Independent wineries are seldom publicly held and are rapidly being acquired by large firms who are increasingly aggressive marketers. Profiles of major competitors are included in Exhibit 3. At the same time, small mom-and-pop wineries have proliferated in the premium wine segment with sales going to local communities. There is little chance that they can expand beyond restricted market areas because of their small size, legal restrictions on interstate wine sales, and the wide variations in their product quality.

12 Most wine sold in the United States is produced in California. Exhibit 4 shows market share by origin of wine. Import prices have generally increased more than domestic prices because of inflation and the devaluation

[3] "Coke Takes a Champagne Chaser," *Forbes,* October 15, 1976, p. 66.

exhibit 2
Major U.S. wineries

Company	*Brands*	*Ownership (date of acquisition)*	*1977 wine sales ($000)*
E&J Gallo	Gallo	Private	$370,000*
United Vintners	Colony Italian Swiss Colony Inglenook	Heublein (1969)	201,751
Franzia-Mogen David	Franzia Mogen David	Coca-Cola Bottling (N.Y.) (1970, 1973)	59,900
Almaden Vineyards	Almaden	National Distillers (1967)	88,023
Canadaigua Wine Co.	Richard's Wild Irish Rose	Public	35,605
The Taylor Wine Co.	Taylor Great Western	The Coca-Cola Co. (1976)	59,600
Paul Masson Vineyards	Paul Masson	Seagram (1945)	70,000†
Mont La Salle	Christian Brothers	Private	50,000*

*Where companies are privately owned, sales figure is based on statement of owner.
†Casewriter's estimate.

exhibit 3
Profiles of major competitors in the wine industry

E&J Gallo

With a sales volume nearly double its closest competitor, Gallo has more influence in the wine industry than any other U.S. company. Because Gallo purchases 40 percent of the California grape harvest, the company is in the position of impacting grape prices through California. In addition to the winery, Gallo operations include vineyards, apple orchards, one of the West's biggest bottling plants, one of California's largest trucking companies, and several big wine distributors. The founders of the winery, Ernest and Julio Gallo, are active in the firm; Julio oversees the wine making and Ernest looks after everything else.

Gallo is the only large winery which doesn't offer tours and Ernest is noted for his secrecy about operations. At the same time, Gallo has served as a training ground for many vintners who have gone on to other companies.

In recent years, Gallo has upgraded its product line and its prices. Once known for pop wines like Thunderbird, Ripple, and Boone's Farm, the company stopped advertising these wines and began to emphasize the higher priced varietal and proprietary wines. Although sales and market share temporarily suffered, profits increased steadily.

Gallo is noted for producing a quality wine at a low price. Hearty Burgundy has been called the best wine ever made for the money and because of the cost advantage of the bottling plant, Gallo has sometimes been in the position of selling wine below cost while making a profit on the bottles.

United Vintners

United Vintners is 82 percent owned by Heublein, Inc., the major U.S. producer of vodka (Smirnoff) and the owner of Kentucky Fried Chicken. The range of

exhibit 3 ***(concluded)***

products of UV included pop wines (Annie Green Springs, T. J. Swann), Colony, Italian Swiss Colony, Inglenook table and dessert wines, and high-quality wines from Beaulieu Vineyards. The company also distributed Lancer's wine from Portugal.

United Vintners has been in the wine industry since the late 60s and is the second-largest seller of wines. Sales totaled $226.1 million in 1976, but fell to $201.8 million in 1977. Recent advertising campaigns have emphasized the personality of the drinker rather than attributes of its wines.

Franzia-Mogen David

Coca-Cola Bottling Company of New York purchased Mogen David in 1970 and Franzia Brothers in 1973. The former is known for sweet table, fruit, and specialty wines while the latter produces a range of California dry red and white wines, table wines, rosé, sparkling, and dessert wines, and brandy. In addition to bottling and distributing soft drinks (Dr Pepper and 7-up in addition to the Coca-Cola line) the company's subsidiaries produce Igloo plastic coolers and other plastic products. The company owns two steamboats, Mississippi Queen and the Delta Queen, and a TV station. It is one of the largest independent soft-drink franchises in the world.

In 1977 wine sales of Mogen David and Franzia brands totaled almost $60 million, down slightly from $60.8 million in 1976; the operations of the Franzia unit were not profitable in 1977. Recent Mogen David commercials urged consumers to drink Mogen David because of its taste—even though it lacked snob appeal.

Almaden

National Distillers and Chemical Corporation acquired full ownership of Almaden in 1977. One of the four largest distillers in the United States, National Distillers was also active in chemicals, petrochemicals, brass mill products, and textiles.

Almaden had sales of $88 million and operating profit of $14 million in 1977; in 1978 sales increased to $117.5 million and operating profits rose to $17.2 million.

Canadaigua Wine Co.

Canadaigua sold primarily dessert wines and one product, Richard's Wild Irish Rose, accounted for over two thirds of its sales. The company owned wineries in New York, California, South Carolina, and Virginia and its 1977 sales were in the $35 million range.

Paul Masson Vineyards

Seagram Company Ltd., of which Paul Masson is a division, was in 1977 the world's largest producer and marketer of distilled spirits and wines. Case volume of Paul Masson wines was reported to be growing about 15 percent annually. The Paul Masson brand enjoyed a good reputation in the industry and was one of the better known brands among customers.

exhibit 4
Market share by origin of wine (1977)

Origin		*Share*	*Volume increase (decrease) from 1976*
Domestic		82.8%	
California	86.1%		6.0%
Others	13.9		(4.1)
	100.0		
Imports		17.2	
Italy	43.0		29.1
France	19.4		12.2
Germany	15.3		18.5
Spain	9.4		(6.1)
Portugal	8.6		3.0
Other	5.0		
	100.0		

of the dollar. The packaging of some French wine in flexible plastic film pouches is one effort to maintain competitive costs.

13 Some wineries own grapevines while others buy from independent growers. For those depending on outside growers (Almaden uses 85–90 percent outside grapes and Taylor 90 percent) relationships with growers are very important. In hard times, the vintner buys grapes to subsidize the growers in order not to jeopardize future supplies. This practice can lead to large inventories and make storage capacity an important factor. Aging requirements for premium and sparkling wines also add to storage requirements. White wines require significantly less aging than red wines of comparable quality. Exhibit 5 shows storage capacities of 12 U.S. wineries which account for 73 percent of the storage capacities of the 100 largest wineries. All except Taylor are in California.

exhibit 5
Storage capacities of 12 U.S. wineries

Winery	*Storage capacity (millions of gallons)*
E&J Gallo	226.0
United Vintners (Heublein)	110.0
Guild Wineries	57.0
Vie Del Co.	37.1
Bear Mountain	36.0
Taylor (Coca-Cola)	31.3
Sierra Wine Corp.	30.0
Almaden (National Distillers and Chemical)	29.4
Franzia Bros. (Coca-Cola, N.Y.)	28.3
Paul Masson (Seagram)	28.0
The Christian Brothers	27.5
A. Perelli-Minette & Sons	20.0

Advertising

14 The entry of large companies into the wine industry has been accompanied by an increase in advertising budgets and the advent of mass marketing techniques. Almaden has increased advertising by 100 percent since 1974 while Taylor's advertising has increased 33 percent. The largest advertiser, Gallo, on the other hand has increased its ad budget only about 9 percent. In 1977, however, Gallo spent over $12 million on advertising while Taylor and Almaden spent about $2 million. Since all segments of the alcoholic beverage industry compete to some extent, the level of wine advertising is partly affected by promotion of beer and spirits.

Regulation

15 Wine is subject to regulation from all levels of government. State and local governments regulate the sales of alcoholic beverages and in some states legislation has been proposed to regulate packaging. At the federal level, the Treasury Department's Bureau of Alcohol, Firearms, and Tobacco (BATF) regulates advertising and labeling. New advertising guidelines were expected late in 1979 and new labeling requirements were to take effect in January 1983. These requirements state that if place of origin (e.g., California) is identified on the bottle, 75 percent of the grapes must be from that place and if a viticultural area is identified (e.g., Napa Valley), 85 percent of the grapes must be from there. These standards match those prevailing in the European Common Market.

16 In addition to regulation, wine is subject to taxation from all levels of government. Federal excise tax is 17 cents per gallon on table wines, 67 cents per gallon on dessert wines, and $3.40 per gallon on sparkling wines.

The Taylor Wine Company

17 The Taylor Wine Company, at the time of acquisition by Coca-Cola, was a leading domestic producer of premium still and sparkling wines, marketed under the Taylor and Great Western labels; it was also the largest producer of premium domestic champagnes. The record of Taylor Wine Company from 1972 to 1976 reflected the cyclical swings in the industry during that period. In 1973, record sales of $51 million registered an 18 percent increase over 1972, with profits up 25 percent to $6.8 million or $1.57 per share. In 1974, sales increased to $56 million while profits increased to $6.9 million or $1.58 per share. Results worsened as Taylor reported sales and profits of $57.6 million and $5.4 million, or $1.24 per share, in 1975 and $59.6 million and $5.6 million, or $1.30 per share, in 1976. In explaining these results, Taylor's management said:

> During the four years 1969–1972, the volume of wine entering U.S. marketing channels increased 10–14 percent per year. As a result of this growth

> and anticipated continued growth, substantial vine plantings and wine production occurred during the period 1971–1974. However, due to economic conditions in 1973 through 1975 the expected rate of growth in wine sales was not realized, and the industry faced a period of surplus wine inventories and grape crops. Taylor believes that its sales for the fiscal years 1975 and 1976 were adversely affected by competitive pricing conditions attributable to the foregoing factors. In its effort to maintain profit margins, Taylor has generally held or slightly increased its prices to distributors during this period, even though, based upon retail prices, it is believed that a number of wine producers have reduced prices. However, inflationary pressures, which increased costs, resulted in reduced profit margin percentages in fiscal 1974 and 1975. A decrease in some material costs and improved cost controls resulted in a modest improvement in profit margins for 1976, although gallons sold declined slightly.

Taylor's 1976 annual report stated that the company had "successfully weathered the recession of the past two years and is in a strong position to take advantage of the recovery the wine industry appears to be experiencing." In addition to the recovery, 1976 also marked the end of the Taylor family's participation in the company's management and its merger with the Coca-Cola Company.

Merger with Coca-Cola

18 On August 6, 1976, Lincoln First Bank of Rochester, New York, put out a preliminary prospectus for sale of 603,000 of the 900,000 shares of Taylor stock it held for trust customers. The motive for the sale was to raise cash for the trusts involved and Taylor was informed of the proceedings because 10 percent of the outstanding stock was involved. Several companies responded to the prospectus including Coca-Cola, PepsiCo., Beatrice Foods, Norton-Simon, and five private investors headed by Marne Obernauer (a former Taylor director and owner of Great Western before it was purchased by Taylor). Coca-Cola was interested in more than the 603,000 shares so when Coca-Cola and the bank reached an agreement, the secondary offer was withdrawn and Coca-Cola entered into merger talks directly with Taylor.

19 After the Taylor board's approval of the proposed merger, Taylor's president, Joseph Swarthout, explained to the shareholders in the December 2, 1976 prospectus:

> The U.S. wine market has never been more competitive. As I stated at our annual shareholders' meeting in September, our major competitors are stronger than ever. In several cases they have significantly stronger financial backing than we have. Under these conditions, it becomes increasingly difficult to improve, or even maintain, our share of market.
>
> I have had the pleasure of being an employee of this company for more than 30 years. I have been a corporate officer since 1955. They have been

> interesting years of growth and opportunity. It is now my firm belief that the Taylor Wine Company would enjoy substantially greater opportunities for success in the future through the financial strength and diversity of the Coca-Cola Company.

20 Industry observers speculated that Taylor management was frightened by several of the unfamiliar companies showing interest in the 603,000 shares of Taylor's stock and looked at the Coca-Cola merger as a way of preventing a greater evil. There did however appear to be possibilities for strategic fit with Coca-Cola, as indicated in Coca-Cola's description of its business:

> The Coca-Cola Company is the largest manufacturer and distributor of soft-drink concentrates and syrups in the world. Its product, Coca-Cola, has been sold in the United States since 1886, is now sold in over 135 countries as well, and is the leading soft-drink product in most of these countries.
>
> In 1978, soft-drink products accounted for 76 percent of total sales and 87 percent of total operating income from industry segments. Soft-drink products include Coca-Cola, Fanta, Sprite, TAB, Fresca, Mr. PiBB, and Hi-C. Brand Coca-Cola accounts for over 70 percent of all company soft-drink unit sales, both in the United States and overseas.
>
> The worldwide soft-drink operations of the Coca-Cola Company are organized into three operating groups: the Americas group, the Pacific group and the Europe and Africa group. The company's largest markets within its Americas group are the United States, Mexico, and Brazil. The largest markets within the Pacific group are Japan and Canada. The largest market in the Europe and Africa group is Germany. In 1978, overseas markets accounted for some 62 percent of total soft-drink unit sales.
>
> In the United States, 67 percent of soft-drink syrup and concentrate is sold to more than 550 bottlers who prepare and sell the products for the food store, vending, and other markets for home and on-premise consumption. The remaining 33 percent is sold to approximately 4,000 authorized wholesalers who in turn sell the syrup to restaurants and other retailers. Overseas, all soft-drink concentrate is sold to more than 900 bottlers. Approximately 90 percent of the syrup and concentrate is sold for further processing outside the company before sale to the ultimate consumer, both in the United States and overseas. The remaining 10 percent is converted into consumable soft drinks before being sold by the company.
>
> Through the foods division, the company manufactures and markets Minute Maid and Snow Crop frozen concentrated citrus juices, Minute Maid chilled juices and related citrus products, and Hi-C ready-to-serve fruit drinks and powdered drink mixes. The Foods division also markets coffee and tea under the Maryland Club, Butter-nut, and other brands, as well as to private label and institutional accounts.

Exhibits 6, 7, and 8 show the combined pro forma summaries of operations, net profits, and balance sheet statements for the merged companies.

21 Under the terms of the merger agreement approved by stockholders of both companies in January 1977, all outstanding shares of Taylor stock were converted into shares of common stock of Coca-Cola at the rate of one share

exhibit 6

THE COCA-COLA COMPANY AND SUBSIDIARIES
AND THE TAYLOR WINE COMPANY, INC.
Pro Forma Combined Summary of Operations (unaudited)
For the Years 1971–1976
($000 except per share amounts)

						Six months ended June 30	
	1971	*1972*	*1973*	*1974*	*1975*	*1975*	*1976*
Net sales	$1,772,029	$1,927,242	$2,201,410	$2,579,754	$2,932,457	$1,476,764	$1,508,416
Cost of goods sold	949,124	1,021,889	1,179,168	1,576,068	1,745,238	904,183	835,472
Taxes on income	165,270	179,661	194,007	173,899	226,750	106,372	129,008
Net profit (Note 1)	173,238	197,004	221,862	201,365	224,951	122,344	144,483
Per share:							
Net profit (Note 1)	2.85	3.24	3.64	3.30	4.01	2.00	2.37
Cash dividends declared	1.58	1.64	1.80	2.08	2.30	1.15	1.32
Average number of shares outstanding (Note 2)	60,730,000	60,860,000	60,937,000	60,996,000	61,050,000	61,049,000	61,078,000

Notes:

(1) In 1974 the Coca-Cola Company adopted the last-in, first-out accounting method for certain major classes of inventories as explained in Note B to the financial statements of the Coca-Cola Company and subsidiaries. For the year ended June 30, 1975, Taylor also adopted the last-in, first-out method of valuation for all its inventories as explained in Note (a) to the Taylor statement of income. These accounting changes had the effect of reducing pro forma net profit for 1974 by $32,329,548 ($.53 a share).

(2) The pro forma average number of shares outstanding represents the average number of shares of the Coca-Cola Company outstanding during each period after giving retroactive effect to the average number of Taylor shares outstanding during each period converted into shares of the Coca-Cola Company on a .267-for-1 basis.

(3) Estimated expenses of this proposed merger will be approximately $700,000. These expenses, which have not been included in the above pro forma presentation, will be deducted from operations of the resulting combined company for the period in which they are incurred.

exhibit 7

THE COCA-COLA COMPANY AND SUBSIDIARIES
AND THE TAYLOR WINE COMPANY, INC.
Pro Forma Combined Net Profit and Per Share Data (unaudited)
For the Years 1971–1976

						Six months ended June 30	
	1971	*1972*	*1973*	*1974*	*1975*	*1975*	*1976*
Net profit ($000):							
The Coca-Cola Company historical	$167,815	$190,157	$214,981	$195,972	$239,305	$119,762	$141,763
The Taylor Wine Company, Inc. historical	5,471	6,847	6,881	5,939	5,646	2,582	2,720
Pro forma combined	$173,286	$197,004	$221,862	$201,365	$244,951	$122,344	$144,483
Net profit per common share:							
The Coca-Cola Company:							
Historical	$2.82	$3.19	$3.60	$3.28	$4.00	$2.00	$2.37
Pro forma combined (Note A)	2.85	3.24	3.64	3.30	4.01	2.00	2.37
The Taylor Wine Company, Inc.							
Historical	1.29	1.57	1.58	1.24	1.30	.59	.63
Pro forma combined (Note B)	.76	.86	.97	.88	1.07	.53	.63
Cash dividends declared per common share:							
The Coca-Cola Company historical	1.58	1.64	1.80	2.08	2.30	1.15	1.32
The Taylor Wine Company, Inc.:							
Historical	.48	.50	.56	.60	.62	.30	.31
Pro forma combined (Note B)	.42	.44	.48	.56	.61	.31	.35
Book value per common share:							
The Coca-Cola Company:							
Historical							$21.57
Pro forma combined (Note A)							22.13
The Taylor Wine Company, Inc.:							
Historical							13.67
Pro forma combined (Note B)							5.90

Notes:
(A) Pro forma combined amounts per share for the Coca-Cola Company are based on average number of shares outstanding during each period and as of June 30, 1976 after giving retroactive effect to the conversion of Taylor shares into shares of the Coca-Cola Company on the basis of the exchange ratio for the merger, at .267 shares of the Coca-Cola Company for each share of Taylor.
(B) Pro forma combined amounts are based on .267 shares the Coca-Cola Company exchanged for each share of Taylor.
Source: Prospectus.

exhibit 8

THE COCA-COLA COMPANY AND SUBSIDIARIES
AND THE TAYLOR WINE COMPANY, INC.
Pro Forma Combined Condensed Balance Sheet
As of June 30, 1976
($000, unaudited)

	The Coca-Cola Company	*Taylor*	*Adjust-ment (note)*	*Pro forma combined*
Assets				
Current assets:				
Cash	$ 78,571	$ 1,173		$ 79,744
Marketable securities	229,793			229,793
Trade accounts receivable—net	250,947	4,366		255,303
Inventories	374,920	41,766		416,686
Prepaid expenses	28,467	180		28,647
Total current assets	962,698	47,475		1,010,173
Property, plant, and equipment—net	647,684	26,462		674,146
Other assets	209,641	902		210,543
Total assets	$1,820,023	$74,839		$1,894,862
Liabilities and Stockholders' Equity				
Current liabilities:				
Notes payable including current maturities of long-term debt	$ 24,891	$ 3,037		$ 27,928
Accounts payable and accrued accounts	337,129	3,656		340,785
Accrued taxes including taxes on income	121,763	1,729		123,492
Total current liabilities	483,783	8,422		492,205
Long-term liabilities and deferred taxes	44,092	6,904		50,996
Total liabilities	527,875	15,326		543,201
Stockholders' equity:				
Common stock—no par value, the Coca-Cola Company	60,485		$ 1,173	
Common stock—$2 par value, the Taylor Wine Company, Inc.		8,707	(8,707)	
Capital surplus	87,938	9,930	7,534	105,402
Earned surplus	1,159,090	40,876		1,199,966
Treasury shares	(15,365)			(15,365)
Total stockholders' equity	1,292,148	59,513		1,351,661
Total liabilities and stockholders' equity	$1,820,023	$74,839		$1,894,862

Note: The pro forma adjustment reflects the issuance of 1,161,000 common shares of the Coca-Cola Company upon conversion of each of the presently issued common shares of Taylor for .267 common shares of the Coca-Cola Company pursuant to the terms of the merger.

of Coca-Cola stock for each 3.75 shares of Taylor stock. No changes in Taylor management were planned and the company was to operate as a wholly owned subsidiary of Coca-Cola with Coca-Cola officials on its board of directors. Exhibit 9 shows the stock price movements for Coca-Cola and Taylor.

exhibit 9
Comparative stock prices

	Taylor common stock		*The Coca-Cola Company common stock*	
	High bid price	*Low bid price*	*High sale price*	*Low sale price*
1974				
First quarter	$38.25	$23.75	$127.75	$109.50
Second quarter	24.25	16.50	118.375	98.375
Third quarter	17.75	12.25	109.00	48.00
Fourth quarter	13.75	9.25	68.75	44.625
1975				
First quarter	20.875	10.125	81.50	53.25
Second quarter	19.50	16.00	93.50	72.75
Third quarter	18.375	11.00	92.00	69.625
Fourth quarter	15.375	10.75	89.75	69.875
1976				
First quarter	17.50	13.50	94.25	82.00
Second quarter	15.50	12.25	89.00	77.625
Third quarter	19.375	12.875	89.625	82.875
Fourth quarter, November 20, 1976	20.25	16.875	86.25	76.25

The Coca-Cola Company announced that it had entered into merger negotiations with Taylor on September 8, 1976, and preliminary agreement on the exchange rate was announced on October 14, 1976.

Taylor Wine Company operations

22 At the time of the merger proposal, Taylor described its operations as follows:

> Taylor is a leading domestic producer of premium still wines. It is also the largest domestic producer of sparkling wines using the traditional French method of fermentation in the bottle, as contrasted with the bulk process in which the wine is fermented in large volume.
>
> Taylor's 63 types of sparkling and still wines are produced and marketed exclusively under two trade names representing its two wine divisions. The Pleasant Valley division, the successor to the Pleasant Valley Wine Company, acquired by Taylor in 1961, produces and markets its wines under the Great Western name. Historically, these divisions have utilized separate production and marketing techniques, and the wines produced by each division traditionally have had different characteristics and consumer brand loyalties. As a result, they have continued as separate divisions since 1961 and presently maintain their own advertising, marketing, productive and storage capacity, and operational staffs, although legal, financial, accounting, personnel, and other functions are performed at the corporate level.
>
> Wines are classified as either still or sparkling. Still wines containing 14 percent or less alcohol are generally referred to as table wines and those containing 14–21 percent alcohol are generally referred to as dessert wines. Sparkling wines are those which are effervescent and contain not more than 14 percent alcohol.

Employees

23 Taylor employed approximately 670 full-time employees. Due to increased use of mechanized harvesting equipment, the number of seasonal workers hired by Taylor had declined in recent years. Approximately 15 seasonal workers were employed during the 1976 grape harvest as compared with approximately 200 such workers employed during the 1967 harvest. A few additional seasonal workers were sometimes employed at the winery for the grape pressing operations. Taylor maintained a pension plan to which it made annual contributions and which allowed employees to make voluntary contributions; it also provided group life and medical benefits for its regular full-time employees. The employees of Taylor were not represented by any unions, and Taylor believed that its employee relations were satisfactory.

Marketing

24 Taylor's wines were sold throughout the United States. Both Taylor and Pleasant Valley advertised through television, magazines, and newspapers. In addition, each division provided promotional materials to its customers for eventual use by retailers. In recent years, advertising, sales promotion, and selling expenditures by Taylor approximated 17 percent of net sales.

25 In 1976 the Taylor and Great Western product lines were marketed by 64 and 34 salesmen, respectively. Taylor's products were sold primarily to 490 wholesale distributors and through 27 brokers. With few exceptions, Taylor and Great Western wines were handled by different distributors in the respective geographic locations. Brokers were primarily used by Taylor to sell its products in states where no distribution agreements existed and in some of the 15 "control" states where Taylor's customer was the local or state agency that controlled the purchase and distribution of alcoholic beverages. In some control states, such as Pennsylvania, sales were made directly by Taylor to the appropriate governmental agency. (A distributor purchases Taylor's products for resale to retailers, whereas brokers act on behalf of Taylor on a commission basis.) Taylor maintained one price list for all purchasers (FOB the winery) and did not engage in selective discounting.

26 In 1976, no distributor accounted for more than 7 percent of Taylor's net sales, and no state control agency accounted for more than 10 percent of Taylor's net sales except Pennsylvania which accounted for 11 percent. The largest markets, by state, for Taylor's products were New York, Pennsylvania, New Jersey, and Illinois. In addition to the wine sold through the distribution channels outlined above, a small volume of wine was sold by Taylor directly to airlines and exported to U.S. armed forces, embassies and consulates abroad, and some foreign countries.

27 Taylor's sales volume was seasonal and was affected by price adjustments and the introduction of new products. Normally, sales volume was greatest in the last calendar quarter and smallest in the third calendar quar-

ter. Sales volume for the first and second quarters was normally about the same. Preannounced price increases and new product introductions typically resulted in anticipatory buying by Taylor's customers. In addition to normal and continuous product advertising, it was Taylor's practice to conduct individual promotional programs at various times during the year for certain of its wines and brands.

28 The vast majority of Taylor's products were bottled in one-fifth gallon (25.6 oz.) and 1.5 liter (50.7 oz.) sizes. Metric conversion was legally required as of January 1, 1979 and, at that time, the one-fifth gallon size was expected to be converted to a .75 liter (25.4 oz.) size. In early 1976, Taylor converted the half-gallon (64 oz.) size to 1.5 liter size. Taylor did not produce wine for bulk sale to other wineries. Exhibit 10 shows the market sizes and Taylor's position in the table, dessert, and sparkling wine segments.

exhibit 10

Marketing of wines in the United States (000 gallons)

	1971	*1972*	*1973*	*1974*	*1975*
Table wines*					
U.S.-produced	159,510	182,640	190,469	201,634	219,171
Foreign-produced	26,356	37,741	45,658	42,153	40,524
Total	185,766	220,381	236,127	243,787	259,695
Taylor	2,840	3,504	4,574	5,123	5,264
Taylor market share†	1.5%	1.6%	1.9%	2.1%	2.0%
Dessert wines*					
U.S.-produced	87,551	86,976	82,637	78,447	80,659
Foreign-produced	8,023	7,325	7,487	7,437	6,867
Total	95,574	94,301	90,124	85,884	87,526
Taylor	4,420	4,465	4,577	4,752	4,683
Taylor market share†	4.6%	4.7%	5.1%	5.5%	5.4%
Sparkling wines					
U.S.-produced	22,005	20,323	18,935	18,008	18,424
Foreign-produced	1,877	1,976	2,081	1,804	1,928
Total	23,882	22,299	21,016	19,812	20,352
Taylor	1,697	1,738	1,763	1,688	1,605
Taylor market share†	7.1%	7.8%	8.4%	8.5%	7.9%
Total of all categories					
U.S.-produced	269,066	289,939	292,041	298,089	318,254
Foreign-produced	36,156	47,042	55,226	51,394	49,319
Total	305,222	336,981	347,267	349,483	367,573
Taylor	8,957	9,707	10,914	11,563	11,552
Taylor market share†	2.9%	2.9%	3.1%	3.3%	3.1%

*Still wines with less than 14 percent alcohol have been included in table wines and those with greater than 15 percent alcohol have been included in dessert wines.

†Taylor as a percentage of total.

Source: Wine Institute Statistical Reports for other than Taylor statistics.

Wine production

29 During the last five years, vineyards owned and operated by Taylor supplied approximately 10 percent of its annual grape requirements. Taylor had over 850 acres of vineyards in production, with an additional 450 acres of such

plantings not yet in full bearing. Of the 450 acres, 420 acres overlooking Seneca Lake, the largest of the Finger Lakes, were recently purchased and planted and were expected to be in full bearing by 1980. The balance of Taylor's annual grape requirements was supplied by more than 450 independent growers from approximately 11,500 acres, located principally in the Finger Lakes region of New York State. A portion of Taylor's grape requirements was purchased from counties in the far western part of New York State.

30 Taylor had contracts with all independent growers from whom it purchased grapes, and a large number of these growers had been supplying Taylor for many years. These contracts required Taylor, on or before August 1 of each year, to announce the prices it would pay for grapes to be purchased in the fall harvest as well as the quantities it would purchase. Taylor financed its grape purchases through short-term financing. Harvesting generally occurred for approximately eight weeks in September and October. Growers had the right to cancel their contracts during the first two weeks of August; and during November of each year, either the grower or Taylor could cancel the contract. In the past five years, four growers exercised their cancellation rights. On July 30, 1976, Taylor announced it would purchase approximately 70 percent of the grape tonnage purchased in 1975; this was the first time that the announced quantities did not constitute substantially the entire crop of its growers under the contract. The average per-ton price paid to growers for grapes for the 1976 harvest was approximately 86 percent of that paid in the 1975 harvest. The company maintained an advisory service program for its independent grape growers, providing them with information with respect to fertilization, cultivation, soil analysis, disease control, and planting. In addition, it conducted experimental work in its own vineyards and in conjunction with the New York State Agricultural Experiment Station located in nearby Geneva, New York.

31 Taylor purchased about 25 percent of its wine needs from several California suppliers for blending purposes and also bought ingredients for certain wines the flavor characteristics of which were derived from grapes not grown in the eastern United States. In addition, wine spirits, sugar and other ingredients, and packaging materials were obtained from several sources. The company believed its sources of supply were adequate and anticipated no shortage in the foreseeable future of grapes supplied by independent growers or of land suitable for growing the varieties and quality of grapes required for its wines.

32 Taylor's current manufacturing facilities had a total bottling capacity of approximately 4,070 cases per hour. Aging of Taylor's sparkling and still wines normally took up to two years, although wines could be stored for substantially longer periods. As a result of this aging process, and to guard against crop shortages, Taylor, like many companies in the wine industry maintained inventories that were large in relation to sales and total assets. The company's inventories usually peaked in late October shortly after the

grape harvest. In October 1975, Taylor's wine inventories totaled 25.2 million gallons. This figure declined to 20.7 million gallons in July 1976 and then rose again to 25.5 million gallons in October 1976, Taylor had approximately 31.1 million gallons of wine storage capacity, of which 24.7 million gallons was tank storage and 6.4 million gallons was bottled storage. Because of operating limitations, the effective tank storage capacity was limited to approximately 85 percent or 21 million gallons. On June 30, 1976 the cost (LIFO basis) of Taylor's inventory of still wines in bulk and sparkling wines in process was approximately $30.8 million.

Acquisition by Coca-Cola

33 Analysts on Wall Street identified several factors that seemed to make the Taylor acquisition a bargain for Coca-Cola. By maintaining premium prices while others were cutting prices, Taylor had maintained its profitability and its record of increasing dividends. Although not investing heavily in such capital projects as a bottle factory, the company had kept its facilities up to date and in good shape. The slipping market share and lack of national image for Taylor were the kind of problems that Coca-Cola's $387 million in cash could solve. Taylor was not deep in debt, was profitable, and in a position to capitalize on what Coca-Cola saw as another wine boom.

34 Coca-Cola's decision to enter the wine industry was discussed in its publication, *Refresher USA:*

> Our company's figurative foray into the vineyards came only after a very careful study of the market, a study which revealed some extremely positive indication of growth potential for wine in this country.
>
> The study's major conclusion was that the wine boom that began in the United States in the 1960s will continue through the 1970s and beyond. In other words, the popularity of wine is here to stay.
>
> "More than 60 percent of the adult U.S. population now consumes wine, which has become an everyday dinner beverage in many households," says Thomas Muller, manager of administration and development for the Wine group (changed to Wine Spectrum in 1978). "And as distribution expands from specialty stores to supermarkets, women are becoming an increasingly important group of purchasers as well as consumers of wine."
>
> Another major factor favorably affecting sales, says [Albert] Killeen [president of the Wine Spectrum] "is an accelerating general cultural interest in wine. There's almost an art form to it that could be called 'winesmanship' as people gain more knowledge about wine.
>
> "There's great interest in such activities as wine tasting, vineyard tours, and wine with food. Many people are studying how to develop a wine cellar, the ritual of chilling, de-corking, decanting, and serving wine."
>
> "Among college students there is a decided preference for wine over other alcoholic beverages," observes Grant Curtis, vice president and marketing services manager for Taylor Wine. "To give you an idea of what an important growth factor that is, there are 28 million college graduates in the

United States today; by 1985, there will be nearly double that number—45 million. And these young adults are carrying their preference for wine into their postcollege lives."

Building the Wine Spectrum division

35 After the Taylor acquisition, Coca-Cola purchased two California vineyards. Sterling Vineyards was the 100th largest winery in the United States with a capacity of 60,000 cases per year. Sterling president Michael P. W. Stone described his product:

> We are one of the half-dozen or so of the smaller California wineries which seek to position their products at the extreme upper spectrum of the premium line of wines. Wines generally are classed as standard, medium-range, and premium: we are aiming to be what you might call "super-premium."

The winery's four red and four white wines were grown and bottled on premises and were classified as estate-bottled, vintage wines. Killeen commented on plans for Sterling:

> Sterling Vineyards' development as a wine growing and producing enterprise will remain unchanged. It will continue to have as its objective the production of the finest Napa Valley premium estate bottled wines in the United States. Production will continue to be restricted and the uncompromising practices that have made Sterling Wines highly respected will be continued by the existing staff at Calistoga.[4]

36 The purchase of the Monterey Vineyard near Gonzales, California was announced by Coca-Cola in November of 1977. Monterey County was one of the last regions in California to be planted in wine grapes and its wines have been characterized as having "an intense varietal flavor, thinner body, and more fruitiness and crispness." Monterey was completed in 1975 and much of the production equipment was designed by its president, Richard Peterson, a Ph.D. in agricultural chemistry and former employee of Gallo and Beaulieu. The construction of the winery was somewhat unorthodox—the foundation was laid, then the production equipment was installed, and finally the walls and roof were put up. Monterey owned no vineyards and produced eight varietals and one blend. Production capacity was 7 million cases and storage capacity was 2.2 million gallons.

37 Taylor, Great Western (Pleasant Valley), Sterling, and Monterey became the components of the Wine Spectrum division of the Coca-Cola Company; together, these wine operations made Coca-Cola the fifth largest factor in the U.S. wine industry. Albert E. Killeen served both as executive vice president of Coca-Cola and president of the Wine Spectrum. He had responsibility for directing and coordinating the company's wine interests and served as

[4] "The Coca-Cola Company Acquires Sterling Vineyards," Coca-Cola press release, August 8, 1977.

chair of the board of directors of each winery. He had previously served as corporate marketing director and executive vice president for marketing at Coca-Cola.

38 Killeen assessed the strengths of the components of the Wine Spectrum as follows:

> Taylor is the keystone of the company's wine business because of its reputation for quality, its strong distribution system, and its fine sales organization. The Sterling and Monterey wineries add geographic balance as well as new brands of varietal wines to our product mix. We now have really the best of both worlds—the distinguished tradition of wine making from the Finger Lakes region of New York State known for its fine champagne and sherries, and the fresh and exuberant ambience of the California growing regions, known for their table wines. Even the two California wineries were carefully chosen to balance one another. One is in a region that produces a very fine Cabernet Sauvignon grape, for example; the other, in a much cooler region, fosters some of the best Johannisberg, Riesling, and Grüner Sylvaner grapes available anywhere. So our combination of vineyards puts us in a prime position for taking advantage of opportunities to produce a wide variety of high-quality American-grown wines for optimum acceptance among American consumers and consumers around the world.[5]

39 The importance of the Taylor name to Coca-Cola was illustrated in the following news item:

> Walter S. Taylor, a grandson of the founder of the giant Taylor Wine Company, must take his last name off the labels of bottles containing wine produced by his own company, Bully Hill.
>
> So said federal judge Harold Burke in the United States District Court in Hammondsport, N.Y. yesterday. The judge upheld a request by the Coca-Cola Company, of Atlanta, for an injunction forbidding Taylor to use the name because of confusion over the wine made by Taylor Wine Company, which Coca-Cola had purchased last year.
>
> Taylor had been a vice president of Taylor Wine, but left some years before Coca-Cola acquired control.
>
> Taylor said he planned to appeal the ruling. However, he added, the family name will be scratched out by hand on the Bully Hill bottles, pending resolution of the case. The "Walter S." will stay.[6]

National status sought for Taylor

40 The immediate result of Coca-Cola's acquisition was the introduction of a new line, Taylor California Cellars. The line was composed of four generic wines—chablis, rhine, rose, and burgundy—which were developed and blended by Dr. Peterson of Monterey Vineyards. The wines were bottled at Franzia Brothers, a subsidiary of Coca-Cola of New York. Taylor provided

[5] *Refresher, USA* 4 (1977), p. 15.
[6] "People and Business," *New York Times*, August 16, 1977, p. 58.

the label name and the distribution system. Prices for California Cellars were set slightly higher than other premium generic wines. The introductory ad campaign for California Cellars became the reason for the BATF dispute.

41 Taylor's advertising agency had commissioned a national consumer group to conduct a series of taste tests to compare the new wines with more established names in California premium wines. The results of the tests placed three California Cellars wines in first place in generic categories and one in second place (see Appendix). Their results were used as a basis for the introductory ad campaign for the fall of 1978 in the East and in southern California.

42 Comparative advertising was a break with traditional wine advertising and there was some question also about whether it was allowed under federal regulations. Taylor sought clearance to use the ads from the Bureau of Alcohol, Tobacco, and Firearms, but was refused. The BATF also refused to prohibit the ads. Taylor then sought court action to gain approval for its commercials but the court ruled that there were no grounds for suit because the ad had not been ordered stopped. Part of the problem resulted from the fact that the bureau was about to review advertising regulations and new guidelines were not expected for a year after the California Cellars campaign was scheduled to begin. The bureau was unwilling to preclear taste test advertising until it had held hearings and developed standards for review. Prohibitions against taste test ads were based on a 1954 ruling dealing with beer. One BATF official stated:

> It is not the bureau's position that all comparative taste test advertising is misleading and therefore prohibited. It is the bureau's position that misleading advertising of wine be prohibited.[7]

The decision as to whether or not Taylor's ads were misleading was to be left until the ads were aired and complaints were filed. In view of the uncertainty surrounding the campaign an alternate series of introductory ads were prepared which did not use taste test information.

43 Penalties for improper advertising ranged from a "letter of admonition" to suspension of vintners' license to criminal prosecution. The possibility of suits from competitors was also present.

Strategies and future outlook

44 Regarding the prospects for the Wine Spectrum division, Coca-Cola stated the following in its 1978 annual report:

> The U.S. wine market is expected to grow at a healthy rate in the years ahead; annual growth in table wines alone may surpass 10 percent. U.S. wine consumption today is at only 5 percent to 10 percent of the per capita

[7] Richard C. Gordon, "Try Taste Test Ads, Taylor Told, But U.S. Won't Give Prior OK," *Advertising Age*, August 21, 1978, pp. 1, 70.

levels of many European markets. Production, packaging, marketing, merchandising, advertising, and promotional programs are now being developed to take advantage of this unique growth opportunity.

The Wine Spectrum units are attempting to exceed industry growth by following these strategies: (1) establish strong production and distribution bases; (2) develop a balanced industry position with quality products from both coasts of the United States; and (3) employ strong and innovative marketing merchandising, and advertising programs targeted at both the trade and the consumer.

These strategies have already resulted in a unit sales increase of more than 10 percent in 1978.

Appendix: Background information on the advertising campaign for Taylor California Cellars

The advertising for the introduction of Taylor California Cellars is based on a scientifically structured and carefully monitored wine tasting test, a study which relied on the objective ratings of a panel of 27 recognized wine experts and which clearly establishes this new brand of premium generic wine as one of the finest of its genre.

To insure the validity and accuracy of the competition, Kenyon & Eckhardt, agency of record for Taylor California Cellars, commissioned the Nationwide Consumer Testing Institute, Inc. (NCTI) to design and implement the tasting test.

The NCTI project sought to determine the rank preference of four brands of California wine in four different categories.

Specifically, the wine tasting competition included the following four tasting tests:

I. A. Chablis tasting:
   Almaden Mountain White Chablis.
   Inglenook Navalle Chablis.
   Sebastiani Mountain Chablis.
   Taylor California Cellars Chablis.

B. Rosé tasting:
   Almaden Mountain Nectar Vin Rosé.
   Inglenook Navalle Vin Rosé.
   Sebastiani Mountain Vin Rosé.
   Taylor California Cellars Rosé.

C. Rhine tasting:
   Almaden Mountain Rhine.
   Inglenook Navalle Rhine.
   C. K. Mondavi Rhine.
   Taylor California Cellars Rhine.

D. Burgundy tasting:
   Almaden Mountain Red Burgundy.
   Inglenook Navalle Burgundy.
   Sebastiani Mountain Burgundy.
   Taylor California Cellars Burgundy.

II. Panel of experts:

To reach the highest standards of integrity, the tasting tests required a panel of qualified and unbiased wine tasters, in a blind study, to rank each wine according to preference.

Appendix ***(concluded)***

Careful and detailed screening procedures governed the search for the wine tasters to participate in the test. NCTI specified, for instance, that no taster could have any financial interest in or affiliation with: a wine producer (wholesale or retail); any publication dealing with wine or reviewing the quality of wine; or a restaurant. Nor could any participant be associated with an advertising agency or market research firm.

As a further requirement, each participant had to have a minimum of five years' tasting experience and was required to average at least 12 tastings per year.

NCTI chose the San Francisco Vintners Club, a nonprofit private wine tasting group, as a starting point for recruitment because of its reputation within California wine tasting circles. The club also is not affiliated with any wine producer and its members routinely participate in weekly wine tastings, generally organized according to the identical principles and 20-point Davis rating system the NCTI intended to use in its own study.

Sixty-four percent of the 27-member panel was chosen from this group. The remainder was composed of other serious wine tasters who were members of such other respected wine tasting societies as Les Amis du Vin, Knights of the Vine, and Berkeley Food and Wine Society. Like the tasters from the Vintners Club, each participant was chosen for his or her experience and familiarity with tasting protocol.

The resulting lineup of participating tasters far exceeded those initial qualifications. Most of the respondents had well over 5 years of tasting experience and several had 20 years or more. In fact the 27 panel members averaged 12.3 years of wine tasting experience.

Likewise, the frequency with which each panel member participated in wine tasting tests averaged 50 per year, far exceeding the minimum standards established by NCTI.

III. Test procedure:

The details of the testing procedure itself were no less demanding than those governing the selection of the panelists. The wine tasting format of the Vintners Club was chosen as the model to be followed by NCTI, specifically because of the club's meticulous and established protocol, including the use of the 20-point Davis rating system.

The tastings were conducted on July 22, 1978, in San Francisco at the Stanford Court Hotel.

Identical settings and procedures were replicated for each of the four wine tastings. All wine was served in odorless glasses marked only by A, B, C, or D.

In accordance with standard tasting procedures, the panelists moved from tasting the drier wines first to the sweeter wines. Within this order—chablis, rosé, rhine, burgundy—the individual wines were also rotated so that, for example, glass A contained a different brand of wine in each test.

Great care was also taken in the purchase of the competitive wines to ensure that the competitive wines in the tasting were also recently bottled. Naturally, each of the wines was served at the appropriate temperature.

IV. The results:

Using the 20-point Davis rating system, the tasters evaluated 10 different properties of each wine and ranked the four wines in each test in order of preference.

When the results were tabulated, Taylor California Cellars was judged superior in the rosé, burgundy, and rhine tastings and a very close second in the chablis tasting.

case 16

Coca-Cola Wine Spectrum (B)

1 In September 1978, Coca-Cola's Wine Spectrum division aired its first comparative taste test commercials for Taylor California Cellars wines. Industry reaction was swift and emotional. One anonymous competitor accused Taylor of "ushering in an era of laundry bleach and detergent advertising into the wine industry" with mass merchandising methods which "are wholly inappropriate to the wine business."[1] The marketing director of Sonoma Vineyards said the approach would:

> shoot the camaraderie of the industry all to hell. I can walk into any winery in the state and be shown the entire process used for wine and ask how they got a particular characteristic I liked in their wine. But if I ran ads saying that my wine is better than theirs, they'd lock the doors on me.[2]

Another competitor accused Coca-Cola of transferring the Pepsi Challenge to wine.

2 Marvin Shanken, editor of *Impact*, the wine industry newsletter, assessed the situation for the industry as follows:

> The implications of Taylor's move are vast and far-reaching because they are likely to force Almaden, Inglenook, Paul Masson, and Gallo to substantially increase their ad budgets—particularly in broadcast—in order to defend their market position.
>
> Until now, California vintners have really looked down their noses at wineries outside of California. Taylor is now demonstrating that it is not a weak sister. With a flow of quality wine coming from Monterey Vineyards, coupled with Sterling Vineyards giving Coca-Cola access to specialty retail outlets and fine restaurants, there's no way California vintners can stop Taylor from becoming a major force in this business. Only the consumer can do that.[3]

3 Of more immediate concern than the possible creation of ill will among vintners was the growing threat of legal action against Coca-Cola. By the middle of October, three complaints had been received by BATF, and Almaden was reported considering a suit. By the end of October, BATF had asked the members of the original testing group for sworn statements as they

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[1] "Competitor Rips Taylor Ads," *Advertising Age* 49 (October 9, 1978), pp. 1, 117.

[2] Ibid.

[3] Ibid.

investigated criminal prosecution. The other vintners whose wines were named in the commercials joined Almaden in considering civil action.

4 Coca-Cola's criminal liability depended on whether or not the ads would be found to be misleading by BATF. The company and its ad agency, Kenyon and Eckhardt Advertising, Inc., argued that they were not misleading in any way. This argument was based on the fact that the test was conducted by an independent research organization.

5 The arguments on which suits or prosecution would most likely be based rested on several observations:

1. The so-called experts cited by Taylor turned out to be not experts at all but merely members of wine clubs.
2. These experts could be shown to have no special knowledge about wines at all.
3. The test comes down simply to a matter of personal preference on the part of individuals which is meaningless to the viewer.
4. California Cellars' higher price puts it in another category and thus it should not be compared to other generic premium wines.

This line of reasoning if supported in court would find the commercials misleading on two counts: the expertise of the tasters and the comparability of the wines. If a criminal proceeding was begun, corporate executives would be defendants.

case 17

Merrill Lynch & Co.: The movement toward full financial service

1 In 1977, Merrill Lynch & Co., Inc., was a leading financial services company. Through its subsidiaries, Merrill Lynch offered a broad range of services that were tailored to the varying financial and investment needs of individuals, corporations, institutions, and governments. While Merrill Lynch strived to expand its position as leader in the securities business, in recent years it had also expanded beyond that industry to fulfill its commitment to better serve the financial needs of its customers. Merrill Lynch was considering the "Cash Management Account" to give customers full financial service and to help offset the cyclical nature of their commissions earnings. The Cash Management Account would represent a further move into the banking industry by providing bill-paying, record-keeping, checking, and credit transactions services.

Historical background

2 Charles Merrill began the firm of Charles E. Merrill & Co. in January 1914. Initially the firm occupied a space sublet from Eastman, Dillon, but by May 1914 had moved to 7 Wall Street. In July of that year Merrill persuaded Edmund Calvert Lynch to join him in a co-partnership agreement, and the firm became known as Merrill Lynch & Co. The new firm followed through on Merrill's and Lynch's personal philosophy for success: there are many potential investors, beyond the elite, which Merrill Lynch could cater to. These small investors represented a segment which the old brokerage houses had ignored.

3 During the early years, Merrill and Lynch emphasized the importance of developing their clients' trust of the partners as financial advisors. Merrill Lynch's first newspaper ads, inviting the public to invest in stocks and bonds, were also designed for maximum credibility. One of the first Merrill Lynch ads was a full-page spread in a newspaper, running eight columns of small type, explaining the fundamentals of stocks and bonds. The Merrill Lynch monthly investment plan was one of the first marketing campaigns on Wall Street to appeal directly to the small investor, and the firm was also one of the first proponents on Wall Street of lower commission rates.

This case was prepared with the assistance of Russell Furtick, Larry Keele, and Richard Mathis by John A. Pearce II of the University of South Carolina.

4 Merrill Lynch & Co.'s first big deal, completed in 1915, was an offering of McCrory Stores. Through the 1920s, Merrill Lynch introduced the investing public to some up-and-coming retail enterprises, including J. C. Penney, National Tea, Western Auto Supply, First National Stores, People's Drug, and a couple of retailers that would become today's Winn-Dixie.

5 Merrill Lynch also played a major role in bringing several industrial companies to market. Many of these were in areas not then accepted by the financial establishment, such as automobiles, movies, and oil. As the Great Depression began in the late 1920s, Charles Merrill foresaw a prolonged period of suffering for Wall Street, and he decided to retrench and withdraw from the retail commission business and concentrate on investment banking. He sold the firm's retail business and branches to E. A. Pierce and Co. in early 1930, thus transferring many of Merrill Lynch's employees to Pierce. At the time, Pierce was the nation's largest wire house with extensive branch networks connected by private telegraph wires.

6 E. A. Pierce and Company survived the Depression. The return on partners' capital was small, however, and with the 10-year partnership agreement due to run out at the end of 1939, there was growing doubt that enough partners were willing to renew.

7 At this time Winthrop Hiram Smith, who ran Pierce's Chicago office, was extremely concerned whether the E. A. Pierce and Co. partnership would be renewed. Smith, who had previously been employed by Merrill, approached Merrill about resuming work with him, bringing together Merrill Lynch and E. A. Pierce.

8 Merrill knew that brokerage firms were experiencing a slump in activity. There was a large amount of distrust, disinterest, and misunderstanding of the financial markets, and stockbrokers were widely regarded as dishonest. In 1936, Merrill met Ted Braun, a leading public relations expert who had done several studies on public attitude. One of Braun's studies outlined what people wanted in a securities firm. Merrill used this study as the organizational blueprint for a new company which would cater to a mass of investors and would be guided by the principles of scientific management. The new firm was ready for business on April 1, 1940, as Merrill Lynch, E. A. Pierce & Cassatt. Cassatt was the long-established Philadelphia firm of Cassatt and Co., which had been sold to E. A. Pierce in 1935.

9 The new company made itself known to the public through attention-drawing advertisements, with the initial announcement stating Merrill's policy. Referred to as the "Ten Commandments," the first stated: "The interests of our customers MUST come first."

10 By 1941 Merrill Lynch wanted not to be known merely as the nation's largest wire house, but also wanted acceptance of itself and Wall Street as essential public institutions. Its new policies and ideas caused a large response nationwide. More than 12,000 new accounts were opened before the end of 1940, which is impressive considering total customers at year end totaled only 50,000. Then, completely unprecedented, Merrill Lynch pub-

lished an annual report. This move was even more surprising, for it showed a loss of $309,000 for the nine months the company operated in 1940. Since 1941, however, the company has been profitable each year.

11 In August 1941 there was a major addition to Merrill Lynch, and the firm became known as Merrill Lynch, Pierce, Fenner & Beane. Fenner was the founder of Fenner and Solari, which teamed with Alpheus C. Beane, Sr., in 1905. Fenner and Beane had been a large cotton house and had developed a large network of branch offices specializing in commodity futures. Fenner and Beane, upon deciding to handle its own stock business, became the second-largest wire house behind Pierce. The merger of Fenner and Beane with Merrill greatly strengthened Merrill's commodities trading.

12 Merrill Lynch continued to be innovative, and in 1945 they initiated the first training program for brokers. Merrill and Smith felt that training their own young executives would enable them to make a broker's career more inviting and would therefore attract top-flight candidates. Since the first training school class in 1945, Merrill Lynch has graduated more than 20,300 account executives from its program.

13 In addition to educating his employees, Charles Merrill believed strongly in educating the public. He wanted to show people how to become investors, to teach them to invest intelligently, and to supply them with data and analysis of specific investments. Merrill's long-time advertising director, Lou Hengel, put out a series of famous educational ads and pamphlets. In addition, Hengel wrote the best seller, *How to Buy Stocks*, which has more than 4 million copies in print.

14 Charles Merrill also emphasized the importance of providing meaningful research information to all investors. In further serving investors, Merrill made certain that their business was properly processed. This was known as the backstage function. To help in the proper processing of business, Merrill brought in an administrator, Michael W. McCarthy, who had previously worked with Merrill. McCarthy worked to establish procedures and installed the machines, systems, and people needed for Merrill Lynch to continue progressing. The progress McCarthy achieved since the mid-1940s is well illustrated by the following incident. In 1947 the U.S. Department of Justice filed antitrust charges against 17 major investment-banking firms, but Merrill Lynch was not even mentioned in these cases.

15 Upon Charles Merrill's death in 1956, McCarthy was appointed as the new managing partner. Alpheus C. Beane, Jr., son of the late co-founder of Fenner and Beane, decided to withdraw from the firm because of his disapproval of McCarthy, and so in early 1958 the company became Merrill, Lynch, Pierce, Fenner & Smith.

16 Not until 1953 did the New York Stock Exchange permit brokers to incorporate. Five years later, in 1958, only 51 (mostly small) of 655 brokerage firms had done so. The 119 partners of Merrill Lynch were planning to become incorporated, again showing Merrill's leadership in the industry, for at that time they were already the world's largest brokerage firm (see Exhibit

exhibit 1
1959 brokerage and underwriting standings

	Fifteen biggest brokers—gross income ($ millions)		*Fifteen leading underwriters—corporate underwritings managed or co-managed ($ millions)*	
1.	Merrill Lynch	$136	First Boston	$1,042
2.	Bache	38	Morgan Stanley	965
3.	Francis I. du Pont	31.2	Lehman	880
4.	E. F. Hutton	30	Blyth	868
5.	Paine, Webber, Jackson & Curtis	29.1	White, Weld	833
6.	Dean Witter	*	Merrill Lynch	815
7.	Walston	27.2	Kuhn, Loeb	696
8.	Goodbody	24.8	Halsey, Stuart	650
9.	Shearson, Hammill	24	Eastman Dillon	456
10.	Loeb, Rhoades	23	Stone & Webster	388
11.	Harris, Upham	22	Goldman, Sachs	366
12.	Reynolds	21.6	Dillon, Read	363
13.	Hayden, Stone	21.5	Smith, Barney	358
14.	Eastman, Dillon, Union Securities	*	Kidder, Peabody	275
15.	Thomson & McKinnon	18	Harriman Ripley	245

*Gross income figure not available.
Source: *Fortune*, "The Biggest Broker in the World," August 1960, page 98.

1). Merrill Lynch's reason for incorporating in January 1959 was "to assure continuity of the firm because each partner cannot add to his capital in the firm until after individual income taxes are paid; and because each is liable for the debts or lawsuits of the others, the threat of a capital drain is always present."[1]

17 After much early success, Merrill Lynch continued to remain at the top by actively pursuing new ideas. In 1964, Merrill Lynch acquired the business of C. J. Devine, a leading government securities dealer, forming the base of Merrill Lynch Government Securities, Inc. "We the People" or "The Thundering Herd," as Merrill Lynch is called, continued expansion through further acquisitions. In 1968, Merrill Lynch entered real estate financing by acquiring Hubbard, Westervelt, and Mottelay. Through this acquisition, Merrill Lynch became a major dealer in Ginnie Maes and helped develop such financing innovations as mortgage-backed pass-throughs.

18 A major development took place in 1968 when Donald Regan became president of Merrill Lynch. He became chief executive officer in 1971. With Regan in power, the company grew a great deal. Some of his innovations include putting internally trained financial managers at the top and putting the "business getters," who traditionally filled the top positions in partnerships, farther down the corporate structure. This arrangement was a radical innovation on Wall Street. He also increased computer capacity to upgrade the firm's efficiency and instituted a diversification program.

19 In 1969, Merrill Lynch changed its strategy from seeking small clients to

[1] "The Herd, Inc., *Business Week*, October 4, 1958, p. 30.

trying to attract large accounts. This change in strategy was made possible by the acquisition of Lionel D. Edie & Co., a large investment management and consulting firm.

20 At that time, while Merrill Lynch continued their expansion, many Wall Street firms were entering a disastrous era. Other firms overextended, resulting in their losing track of the trades they made, the whereabouts of the certificates they represented, and the status of their customers' accounts. Many Wall Street firms were unable to meet their obligations and subsequently collapsed, taking their customers' accounts with them. In 1970, the New York Stock Exchange requested Merrill Lynch to take over the fifth-largest retail broker, Goodbody & Co., which was sinking fast. This was a high-risk job for Merrill Lynch even though there were some reimbursement provisions from the total New York Stock Exchange community. The Wall Street crisis which forced Merrill Lynch to take over Goodbody threw Merrill Lynch's long-range plans for greater involvement in the financial services industry off schedule. Merrill Lynch, however, was able to set up important underpinnings of a sound diversification effort by establishing a holding company. This holding company, known as Merrill Lynch & Co., had Merrill Lynch, Pierce, Fenner & Smith as the principal subsidiary. Under this new format, Merrill Lynch, which had already expanded into such areas as government securities, real estate, financing, and economic consulting, diversified farther into specialty insurance, relocation services, and asset management.

21 Throughout the 1970s Merrill Lynch campaigned for a national market system. Merrill Lynch managers felt that the national market system would greatly help their business. If another brokerage firm handled the other side of the transaction, Merrill Lynch wanted that member of the industry to handle the transaction efficiently, thereby making Merrill Lynch more efficient.

22 In 1974, Merrill Lynch acquired Family Life Insurance, a Seattle-based company which specializes in mortgage-protection insurance for homeowners. Also during that year, Merrill Lynch added AMIC, which offers mortgage-default insurance to the institutions that issue mortgages. Merrill Lynch had also become the top-ranked U.S. investment banking house internationally by 1974.

23 In early 1977, Merrill Lynch acquired a company that became Merrill Lynch Relocation Management. This subsidiary contracted corporations to help their employees who needed to transfer. This relocation company also provided Merrill Lynch with the executive expertise to form Merrill Lynch Realty Associates. In June 1977, Merrill Lynch launched a national weekly stock option guide, *Options Alert*. This move represented a major entry into the publishing business for Merrill Lynch and was the result of Merrill Lynch's corporate planning unit, which had been established in May 1975 to further the firm's continuing diversification program into areas not subjected to the market's cyclical nature.

The managerial philosophy of Merrill Lynch

24 To gain and keep its competitive advantage in the financial services field, Merrill Lynch had developed a unique managerial personality for a brokerage house.

The Merrill Lynch concept of management

25 Merrill Lynch worked toward financial diversification through the process of management by objectives, a process rarely attempted on Wall Street. The process involved setting specific long-term and short-term goals—in a continuous succession of one-year, three-year, and five-year plans—for every operating unit and every executive in the company. Also, management by objectives meant having a periodic critical review to see that each unit and manager was on target.

26 Merrill Lynch first brought its strategic planning to life in 1973. The company had until then been product-sales oriented. It had only a few products and services that it sold. The new plan called for Merrill Lynch to be market-oriented, that is, organized around the needs of potential customers. These customers fell into four groups: individuals, corporations, institutions, and governments.

Concentration in financial services

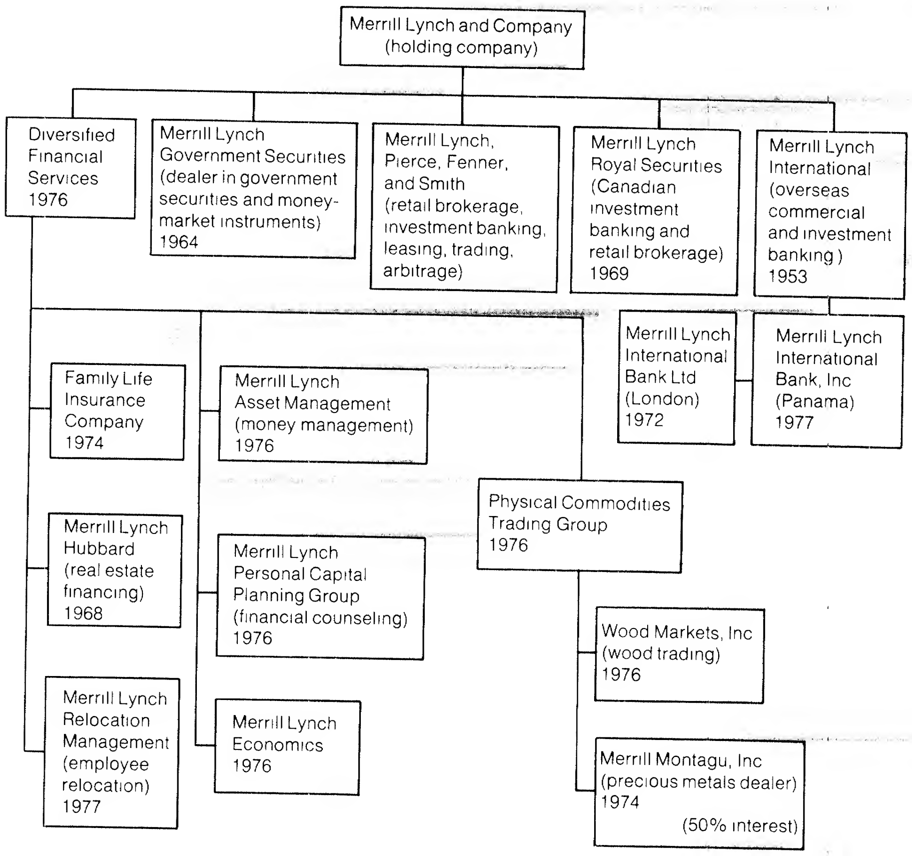
27 By going public in 1971, Merrill Lynch acquired enough capital to undertake a wide range of new ventures. Company officials continually stressed, however, that all diversification efforts would be within the realm of financial services. Merrill Lynch's size gave it the opportunity to try out a variety of new businesses at once. It learned these businesses and either expanded or divested them. It had the ability to experiment, and a failure did not pose as grave a problem for Merrill Lynch as it would for some smaller firms. For example, Merrill Lynch's move from a broker-oriented stock-exchange system to one of dealer markets, where brokers trade with customers from their own inventories, made capital a vital factor.

28 Merrill Lynch was divided into five separate units, as shown in Exhibit 2. These units were (1) the Merrill Lynch, Pierce, Fenner, & Smith brokerage unit; (2) Merrill Lynch International; (3) Merrill Lynch Government Securities; (4) Merrill Lynch Royal Securities (a Canadian subsidiary); and (5) Merrill Lynch Diversified Financial Services.

Services offered by Merrill Lynch

29 Merrill Lynch offered many services. These included corporate securities trading, options and commodity futures, equity trading and arbitrage, and investment banking.

exhibit 2
Merrill Lynch's fast-branching family tree



Dates represent years when units were acquired or established by Merrill Lynch.
Source: "Merrill Lynch: The Bull in Banking's Shop," *Business Week*, August 8, 1977, p. 51.

Corporate securities trading

30 According to the 1977 Form 10-K of Merrill Lynch, the major source of Merrill Lynch, Pierce, Fenner & Smith's (MLPF&S) revenues was from commissions earned as broker, or agent, for its customers in the purchase or sale of common and preferred stocks. MLPF&S had traditionally emphasized its services to individual investors, but in recent years the institutional investor had taken on greater importance. On May 1, 1975, fixed minimum commission rates for brokerage transactions were eliminated by the Securities and Exchange Commission. It became the policy of MLPF&S to negotiate commissions for accounts that are actively traded, including both individual and institutional accounts. Under the MLPF&S Sharebuilder Plan, which involved mass processing of orders, individual customers received discounts on commission rates on transactions of $5,000 or less.

31 Securities transactions made by MLPF&S were executed on either a cash or margin basis. Under the margin transactions, MLPF&S extended credit to customers based on the market value of the securities in the customer's account. To finance customers' margin account borrowings, MLPF&S used its own capital, bank borrowings, and borrowings provided by free credit balances in customer accounts.

Options and commodity futures

32 MLPF&S was licensed to buy and sell options on the Chicago Board Options Exchange, the American Stock Exchange, and in the over-the-counter market. MLPF&S bought and also wrote options for its customers.

33 MLPF&S was a dealer and broker in the purchase and sale of futures contracts in substantially all commodities and held memberships on all major commodity exchanges in the United States and Canada. Since substantially all buying of commodity futures was done on margin, the required margin was significantly lower than that required of common-stock customers. Commodity trading was a high-risk, speculative business, and MLPF&S was exposed to a large amount of financial risk due to the market volatility of commodities.

Equity trading and arbitrage

34 MLPF&S regularly made a market in approximately 650 domestic common stocks and more than 100 foreign securities. Its market-making activities were conducted with other dealers in the interdealer market and in the retail market. As part of its trading activities, MLPF&S engaged in both riskless and risk arbitrage. Whereas riskless arbitrage typically involved the simultaneous purchase and sale of securities, risk arbitrage depended upon the ability to rapidly assess certain market conditions. At Merrill Lynch, all positions were liquidated as soon as possible, and positions in arbitrage were not taken without an analysis of the security's marketability. Merrill Lynch also made a market in municipal obligations and corporate fixed-income securities.

Investment banking and research

35 MPLF&S was a major investment banking firm which was active in every aspect of investment banking in a principal, agency, or advisory capacity. MLPF&S underwrote the sale of securities themselves or arranged for a private placement with investors. MLPF&S also provided a broad range of financial and advisory services for clients, including mergers and acquisitions, mortgage and lease financing, and advice on specific financing problems.

36 To provide its customers with current information on investments and

securities markets, MLPF&S maintained Wall Street's largest securities research division. The research division performed technical market analysis as well as fundamental analysis of fixed income securities and analysis of the municipal and corporate bond markets. MLPF&S had a computer-based opinion retrieval system that published current information and research opinions on approximately 1,500 foreign and domestic corporations.

Other activities

37 MPLF&S sold shares of 191 income, growth, and money market funds, 13 of which were advised by Merrill Lynch Asset Management, Inc. In the money market area, MLPF&S also sponsored municipal investment trust funds, corporate income funds, and government securities income funds. These were all closed-end unit investment trusts which were registered under the Investment Company Act of 1940.

38 MLPF&S also provided transaction clearing services to broker-dealers on a basis which was fully disclosed to the broker-dealers' customers. While the original firm retained all sales functions, MLPF&S handled all settlement and credit aspects of the transaction.

Competition

39 All aspects of MLPF&S's financial services business were extremely competitive. MLPF&S was in direct competition with firms such as Dean Witter, Bache & Co., and E. F. Hutton. MLPF&S also competed for investment funds with banks, insurance companies, and mutual fund management companies. Since the elimination of fixed commissions on May 1, 1975, the security brokerage industry had become intensely competitive. In addition to commissions charged, MLPF&S also competed on the basis of its services to investors, both individual and institutional. The establishment of a national market system, which MLPF&S supported, was intended to provide investors with the benefits of competing market places. Many firms had merged on Wall Street, resulting in securities firms with strengthened financial resources. In turn, these firms provided increased competition to the MLPF&S network of financial services.

40 The life insurance business of Merrill Lynch was also highly competitive. Many companies, like Prudential and Metropolitan, were older and larger than Family Life and provided strong competition because of their strong financial base and large agency organization. However, Family Life did have an advantage, as it specializes in mortgage-cancelation life insurance.

41 Merrill Lynch's operations in the real estate area were divided into two parts: (1) employee relocation and (2) real estate financing, mortgage banking, and real estate management. There were approximately eight companies which provided employee relocation services, with Merrill Lynch Relocation Management Inc. and Homequity, Inc. being predominant in the indus-

try. Of course, numerous organizations were involved in real estate and mortgage banking.

Regulation

42 The securities business of MLPF&S was regulated by several different agencies. Although the SEC provided the bulk of the regulations, MLPF&S was also regulated by the National Association of Securities Dealers, Inc. The securities industry was more highly regulated than many other industries; and violations of applicable regulations could result in the suspension of broker licenses, fines, or suspension or expulsion of a firm, its officers, or employees.

43 As a brokerage firm registered with the SEC and as a NYSE firm, MLPF&S was subject to the Uniform Net Capital Rule which was designed to measure the general financial integrity and liquidity of a broker-dealer. Under this rule, MLPF&S was required to maintain "net capital" equal to 4 percent of the total dollar amount of customer-related assets. Under NYSE rules, MLPF&S had to reduce its business if its net capital was less than 6 percent of its total customer-related assets. Compliance with these net capital rules tended to limit the operation of MLPF&S, especially in underwriting and maintaining the securities inventory required for trading.

The brokerage industry in 1976

44 The aftertax earnings of all New York Stock Exchange brokerage firms increased about 22 percent from 1975, to a total of about $508 million. The total revenues rose 18 percent to $6.9 billion. Profits for the 12 large publicly held brokerage firms showed a 16 percent increase to $230 million and an 18 percent increase in revenues to $2.9 billion.

45 The trading volume also increased in 1976, with the daily trading average up 14 percent to 21.2 million shares. The total dollar value of New York Stock Exchange share volume increased 16 percent to $152 billion.

46 Brokerage firms were depending less on securities commissions and more on other products and services. For the past several years, most of the leading firms increased their diversification and had strengthened their activities not dealing with security commissions. Firms were entering the insurance business, going into foreign brokerage operations, developing new services, and increasing marketing efforts. Investment banking, principal transactions, and commodity trading were being emphasized. Exhibit 3 summarizes some of the effects of diversification on brokerage firms' revenues. In 1976 revenues from securities commissions were about 46 percent of total revenues, as compared to 52 percent in 1975.

47 The number of brokerage firms had been decreasing since 1962 because of closings or mergers of member firms. In the 1970s, several large, respected institutional firms had closed or sought mergers because of the unprofitabil-

exhibit 3
Diversification of the major brokers

	Merrill Lynch	*E. F. Hutton*	*Bache Group**	*Paine Webber*
Brokerage commissions	39%	60%	53%	50%
Trading government, municipal, corporate, and money-market securities	23	10	9	17
Interests on margin balances and securities owned	21	13	17	18
Investment banking	10	14	17	13
Other business	6	3	4	2
Total 1976 revenues ($ millions)	$1,125	$315	$248	$225

* Year ended July 31.
Source: "Merrill Lynch: The Bull in Banking's Shop," *Business Week*, August 8, 1977, p. 52.

ity of keeping large research staffs while the commission rates for the larger accounts had been cut back. Major moves in 1976 were the merger of William D. Witter into Drexel Burnham and the Reynolds Securities International acquisition of Baker, Weeks, and Co.

Expenses increase

48 A major reason for increased expenses in 1976 was that many firms were building their capacity to handle larger volumes of transactions. The attempts to increase capacity had begun in 1975. Many major firms had been increasing their computer and communications capabilities in order to facilitate handling larger volumes of transactions and to put them in a better position to shift to a central market system.

49 Congress and the Securities and Exchange Commission were pushing for the development of a central market system. The central market system was likely to involve sophisticated electronic switching of orders between the various market places. This would make the market a more efficient system. Firms with the most advanced computer and communications capabilities were projected to move into this market easily and with relatively low additional expense.

50 Another factor that increased expenses in 1976 was inflation. Inflation had remained at a level high enough to have a significant impact on costs. The percentage increases were especially high for postage and telephone services, two services which securities firms use very heavily.

Banks' impact on the brokerage industry

51 Several banks had begun offering automatic investment services where particular stocks could be purchased on a monthly basis by the banks' checking account customers. Banks were able to bunch orders together to take advantage of the lower commission rates available on large transactions. In Sep-

tember 1976, Chemical Bank took brokerage services one step farther. It offered retail brokerage rates well below the rates that individuals could get at brokerage houses. Chemical Bank could offer the discount rates because the bank got large discounts itself by placing the orders through Pershing and Co., a New York Stock Exchange member firm. On all but the smallest of orders, the transaction fees from going through Chemical Bank were well below the prevailing retail commissions charged by brokers. Individuals making large or frequent trades would quickly make up the $30 annual fee for access to Chemical's order desk. Chemical also offered safekeeping of the securities.

52 Chemical's plan was forecast to have a significant impact on the securities industry if it was profitable and if Congress did not act to keep them from continuing the plan. The Senate was investigating banks' securities activities and could possibly take action unfavorable to Chemical's service. The Securities Industry Association was also considering asking the Federal Reserve Board or state banking authorities to bar Chemical's brokerage activities. If Chemical could make profits on its brokerage service, and if the activities were made illegal, Chemical's lower rates could cause brokers to lower the rates they charged in order to remain competitive. Such actions would cut further into the profits of the brokerage industry.

The brokerage industry in 1977

53 The 12 large publicly held brokerage companies monitored by Standard & Poor's reported earnings of $60 million in the first half of 1977—down 54 percent from the record $130 million in 1976's first half. In the same period, total revenues declined only 2 percent from the first half of 1976.

54 Brokerage firms were relying less on securities commissions, although they remained the largest source of revenue, and more on diversified products and services. Firms were actively entering the insurance business, expanding foreign brokerage operations, developing new services, and intensifying marketing efforts. In the years 1972 through 1975, investment firms' securities commissions accounted for 52 percent of gross revenues. In 1976, they represented 46 percent, and in 1977, they were 44 percent of the total.

55 In May 1975, fixed commission rates were abandoned on all transactions, regardless of size. Rates, however, did come down slightly, but were expected to come under increased pressure for downward revision because of the proliferation of discount brokerage firms. The major area where competition had driven rates down was in institutional transactions, where rates had fallen 44 percent since April 1975. The impact of discounted commissions on revenues was reflected in the fact that while the dollar value of NYSE trades in 1977 declined 9.4 percent, commission revenues fell 17 percent. The problems of discounts were substantial for some firms. About one third of NYSE member firms lost money in 1977.

56 The decline in the number of brokerage firms continued in 1977. Since

1970, the number of NYSE member firms fell to 370 in 1977 from about 570. The expense of maintaining large research staffs and cutting commission rates had pared profits to the point that many firms had merged, cut back, diversified, or gone out of business. With the decline in the number of firms doing a public business, concentration in the securities industry was increasing. By 1977, the 25 largest firms had 65 percent of the industry's capital, 56 percent of commission revenues, and 64 percent of total revenues.

57 Trading profits continued to grow and account for 20 percent of total revenues in 1977. Trading profits were derived from broker's market-making activities and from interest and dividends on securities held for trading. Because this source of income depended on the value of financial assets, it was a more volatile source of earnings than commission revenues. Likewise, underwriting income was quite volatile, and this source of revenue fell 12 percent in 1977.

58 An increasingly important source of revenues, interest on margin borrowing, accounted for 10 percent of gross revenues in 1977, up from 8 percent in 1976. Such interest income was a relatively stable portion of earnings, tending to bolster profitability when other sources of earnings were down. In fact, retail brokerage operations probably could not be conducted profitably at 1977 rates if it were not for margin lending.

59 In recent years, brokerage firms had noticed increased competition from banks. Several banks continued to offer automatic investment services, where certain stocks could be purchased monthly by checking-account customers. However, Chemical Bank, which had begun to offer brokerage services in 1976, dropped its program as unsuccessful. As of 1977, all bank brokerage services account for less than 1 percent of the total value of transactions on all stock exchanges. Bank expansion of brokerage services in the future was a genuine possibility, however, because of regulatory changes and access to customers' money.

Current situation

60 1977 was a year of declining earnings and profits for Merrill Lynch. Markets were poor in each important area that the corporation serves as broker or dealer. Total commission revenues from listed securities, options, over-the-counter, mutual funds and commodities were expected to drop from $442,947,000 to about $365 million—a decline of over 17 percent. Total principal transaction revenues were also down about 28 percent, falling from $261,285,000 to a projected $188 million. As a result of these declines, net income was expected to fall from $106 million in 1976 to about $44 million in 1977. Earnings had fallen to about $1.25 per share for 1977 as compared to $3.01 per share in 1976. (Statements of Merrill Lynch's financial position in December 1977 are presented in Appendixes A through E.) These declines occurred in a year marked by the uncertainty among both large and small investors. Despite moderate but steady growth in GNP as well as improve-

ment in other leading economic indicators, investors seemed to focus on the negatives.

61 The Federal Reserve had been periodically stepping into the markets to tighten the money supply. Short-term and intermediate-term interest rates were increasing. As a result, trading activities, especially in the fixed income markets, were especially hard hit. Stocks had declined in attractiveness for investment purposes because, with the high interest rates, it was possible to get a good return on an investment by buying six-month certificates. Investors increasingly turned to high-yielding bonds or to holding capital assets for future investment.

62 Merrill Lynch's problems were compounded by lower commission rates. A new era of competition to lower commission rates charged to large investors had begun about the middle of 1975. Merrill Lynch had become involved in the scheme of reduced commissions for larger investors in hopes of attracting the larger accounts. The aggressive approach adopted by Merrill Lynch substantially increased the capital committed to handling large transactions. Merrill Lynch's new policy was to offer discounts to meet those offered by their competitors in order to gain orders and market share, as long as the business attracted by the discounted commissions remained profitable. The policy was one of the major reasons for the increase of Merrill Lynch's share of public New York Stock Exchange volume, which was reversing the downtrend of 1975 and 1976.

63 Merrill Lynch was experiencing increases in revenues in its other traditional areas. The corporation had maintained its position as the leading manager of corporate underwritings and had increased its penetration of the fee-based corporate finance business. Merrill Lynch also ranked first in municipal financing for the third straight year. On an international scale, the American dollar had declined in value against other major currencies. The weakening dollar, in combination with the U.S. securities markets, weakened the confidence of foreign investors and lessened the attractiveness of American securities.

Commercial banking activities

64 With its huge asset base and network of branch offices, Merrill Lynch was in a position to move into activities normally associated with commercial banks. The 1933 Glass-Steagall Act mandated the separation of investment and commercial banks in the United States.

International banking

65 The Glass-Steagall Act had no effect on foreign bank operations since they fell outside U.S. jurisdiction. Merrill Lynch, in fact, already operated commercial banks in London and Panama that took deposits and made loans to overseas corporations. The total capital in these banks reached $50 million

during 1977. From such growth it can be seen that commercial banking activities would offer tremendous financial clout for a financial services firm.

66 Consistent with its strategy to provide a full range of financial services to its customers, Merrill Lynch International wanted to increase its consumer banking activities overseas. However, any expansion into international banking would put the firm in direct competition with U.S. banks' foreign subsidiaries and such universal banks as Deutsche Bank and Union Bank of Switzerland.

Domestic banking—the cash management account

67 Merrill Lynch was considering a type of broker-bank plan that would integrate a wide variety of financial services and, hopefully, circumvent the restrictions of the Glass-Steagall Act. The proposed account, called a cash management account (CMA), would offer a whole range of services such as bill-paying, record-keeping, checking, and credit transactions. The idea for the CMA was recommended by SRI International. Merrill Lynch itself had spent one and a half years developing the conceptual, legal, and computer systems details.

68 The account would allow Merrill Lynch customers to deposit money in a Merrill Lynch money market fund and draw on those funds with either a check or a Visa card. Any unused balances in the customer's brokerage account would be transferred into the money fund once a week and would earn dividends daily. Additionally, those customers with stocks and bonds would also be able to borrow up to 50 percent of the value of those securities on deposit. This ability to borrow against securities would be, in essence, a direct line of credit as well as overdraft protection for checking purposes. Each Cash Management Account customer's securities, including the money market fund shares, would be protected up to $300,000 through the Securities Investor Protection Corporation and supplemental securities protection. The interest on margin loans would be in the range of 6 to 8 percent compared with the 6¾ percent prime rate at commercial banks. However, more pertinent to individuals, the CMA rates would be considerably lower than the 10 to 12 percent conventional automobile loans or the 12 to 18 percent rate on most bank card purchases. Borrowing would automatically be triggered only after all the investment funds had been utilized.

69 Merrill Lynch had contracted the services of City National Bank of Columbus, Ohio, to handle the processing of checks, credit card drafts, and record-keeping. Merrill Lynch would effect payment for CMA holders, extend credit, and provide a consolidated account statement. Both Merrill Lynch and City National saw the system, in which all units would be linked electronically, as the first step in a nationwide system of electronic funds transfer.

70 Merrill Lynch considered its ability as a superior mass merchandiser to be a distinctive competency and an advantage for entering the highly competi-

tive banking field. Also, its national network of offices would be of tremendous benefit in marketing the CMA. In advertising the CMA, Merrill Lynch considered a direct mail and print campaign as most effective. If implemented, the CMA would first be tested in a few pilot cities around the country.

71 Internally, the firm appeared to have the administrative capability to handle a large volume of new inputs. Merrill Lynch's data entry operators had shown great flexibility and adaptability in handling new applications. There was also sufficient capacity available to handle new data with the present systems, as shown by the fact that Merrill Lynch processed work for other companies during its own low-volume periods and work gaps.

Legal implications

72 There were a number of major legal problems that Merrill Lynch had been considering. The firm had had its own and other lawyers working to make sure that the new product would not transcend any legal boundaries, such as the Glass-Steagall Act. It had presented the idea to the Federal Reserve, the Justice Department, and selected members of Congress. The Fed said that the new account would not violate any of its rules but warned that it would closely monitor the impact of this and any similar programs. The Justice Department neither approved nor disapproved the idea. Other anticipated implications were the almost certain outcries from bankers that Merrill Lynch become chartered and regulated by the Federal Reserve System.

73 For several years the issue of separating investment and commercial banks had been blurred. The 1975 Securities Act directed a review of the Glass-Steagall Act. If brought to fruition, the CMA would surely add pressure to redefine or alter such legislation. Meanwhile, banks had been participating in activities that brokers consider to be Glass-Steagall infractions. Such activities included (1) financial advice to customers on long-term credits, mergers, and acquisitions, (2) certain kinds of term loans, and (3) lining up insurance or pension fund money for private placements. The Federal Reserve Board had fully endorsed banks' private placement activities. In response, the brokers' trade group (the Securities Industry Association) denounced the Fed's stand and urged Congress to solve the problem. Also, Congress had been debating the related issues of (1) whether to give interest-bearing checking-account privileges to nonbank thrift institutions and (2) whether to allow interstate branching of banks.

74 In light of the banking-brokerage confrontation, however, Merrill Lynch viewed the CMA move more as a threat to brokers than to large banks. Merrill Lynch was one of the very few brokerage houses large enough to invade the banking business. It had $632 million in capital; its next largest rival had only $167 million. However, while Merrill Lynch was huge in comparison to other brokers, it was small compared to the large money-center banks.

How banking activities could benefit Merrill Lynch

75 Along with Merrill Lynch's other attempts to diversify its financial products and services, the company's move into commercial banking would be an attempt to offset the decreasing profitability and the cyclicality of brokerage profits. In a way, all brokers were already in the banking business through the medium of margin credit. In August 1977 Merrill Lynch topped $2 billion in margin loans—a loan portfolio that only 30 commercial banks could match. These margin loans were very profitable; in fact, 10 percent of Merrill's 1976 revenues came from interest on margin balances.

76 Merrill Lynch had its eye on a much broader source of customers and money through international and CMA banking activities. The CMA would be a way to attract new accounts as well as to hold old accounts. The CMA would have a finely segmented target market—probably the young (ages 35 to 45) executive beginning to build a stock portfolio and who uses unsecured credit. These customers would add money to Merrill's cash reserves and would be good present and future investing clients for Merrill's brokers.

77 Margin loans were more extensively used under the CMA concept. Merrill Lynch held billions of dollars of value in fully paid securities owned by customers which represented billions in potential low-interest borrowing power. Through CMAs, funds that had previously been idle in brokerage accounts could be put to work in an interest-earning fund. The CMA would, in essence, allow margin credit for purchases other than additional securities.

78 The movement into banking would have other effects on Merrill Lynch. First, commercial banking opened up huge possibilities in diversified financial services. Second, the movement into banking could give Merrill Lynch a reputation for cleverness that it lacked. In spite of Merrill's size and scope, it had an image problem. To most observers, it appeared as a giant who had succeeded not through talent, but simply because it was so big. The firm led in most investment fields, but it did not have the classy image of a Morgan Stanley or a First Boston or a Solomon Brothers. Merrill Lynch's movement into banking offered it an opportunity to do something unique. The firm would have the chance to prove its innovativeness and to establish a unique competitive advantage.

Other areas of interest

79 In its effort to become a leader in virtually all areas of financial services, Merrill Lynch was considering many alternatives. It would probably undertake all of them, but the consideration was how soon it would choose to do so. For example, a system of real estate offices throughout the country was on Merrill's forward schedule, assuming its current venture into the employee relocation business worked well. It could also decide to expand its Personal Capital Planning Group, which provided financial planning for

people with $30,000 or more in income, beyond its three test offices into a national branch system. Alternatively, it could move immediately to expand and broaden the product lines Family Life Insurance.

Criteria for accepting a new project

80 Whatever moves Merrill Lynch decided to make, they were to be the result of systematic planning. The company had repeatedly expressed the willingness to sacrifice the possibility of large immediate profits to avoid the probability of large future losses. Any new project had to offer $500,000 in aftertax earnings and to provide a 15 percent aftertax return on investment with a three-year period. Merrill Lynch, in all instances, sought to repeat the successful formula it had used in the past—start small, learn the language and problems of the business, groom it to fit into Merrill's system of controls, and then plow in capital and personnel to grow.

appendix A

Statement of Changes in Consolidated Financial Position
Years Ended December 30, 1977, and December 31, 1976
($000)

	1977	*1976*
Sources of funds:		
Funds from operations:		
Net earnings	$ 43,947	$ 106,608
Noncash charges—depreciation and amortization	19,862	15,584
Total funds provided by operations	63,809	122,192
Increase in borrowings:		
Securities sold under agreements to repurchase	572,819	282,142
Bank loans	168,437	679,756
Commercial paper	239,081	215,070
Borrowing agreements with institutions	78,800	—
Intermediate term loans	102,500	—
Total increase in borrowings	1,161,637	1,176,968
Increase in net payables to brokers and dealers	5,436	54,579
Proceeds from issuance and sale of stock	10,082	11,073
Other, net	(15,062)	95,178
Total sources of funds	$1,225,902	$1,459,990
Uses of funds:		
Increase (decrease) in financial assets:		
Net securities inventory	$ 451,462	$ 815,544
Securities purchased under agreements to resell	233,984	(68,566)
Customer receivables, net	383,988	587,811
Residential properties under contract	74,179	—
Total increase in financed assets	1,133,613	1,334,789
Increase in deferred insurance policy acquisition costs	15,780	11,815
Purchase of office equipment and installations, net of retirements	29,337	18,366
Treasury stock purchased	10,019	24,685
Cash dividends	30,215	28,341
Decrease in income tax liability	8,037	40,507
Increase (decrease) in cash and securities on deposit	(1,099)	1,487
Total uses of funds	$1,225,902	$1,459,990

Source: Merrill Lynch & Co., Inc. 1977 annual report, p. 11.

appendix B

Statement of Changes in Consolidated Shareholders' Equity
Years Ended December 30, 1977, and December 31, 1976
($000)

	Common stock	*Paid-in capital*	*Retained earnings*	*Treasury stock*
Balance, December 26, 1975:				
36,140,179 common shares issued and 571,904 shares in treasury	$48,187	$87,418	$440,330	$ (8,518)
Net earnings			106,608	
Cash dividends: Common stock, $.80 per share			(28,341)	
Common stock sold to employees under stock option and stock purchase plans (587,235 shares held in treasury)		(233)		11,306
Treasury stock purchased (997,900 shares)				(24,685)
Balance, December 31, 1976:	$48,187	$87,185	$518,597	$(21,897)
Net earnings			43,947	
Cash dividends: Common stock, $.86 per share			(30,215)	
Common stock sold to employees under stock option and stock purchase plans (726,782 shares held in treasury)		(5,558)		15,640
Treasury stock purchased (521,900 shares)				(10,019)
Balance, December 30, 1977: (36,140,179 common shares issued and 777,687 shares in treasury)	$48,187	$81,627	$532,329	$(16,276)

Source: Merrill Lynch & Co., Inc. 1977 annual report, p. 10.

appendix C

Consolidated Balance Sheet
December 30, 1977, and December 31, 1976
($000)

	1977	*1976*
Assets		
Cash and securities on deposit:		
Cash (includes time deposits of $33,718 in 1977 and $54,582 in 1976)	$ 84,069	$ 88,406
Cash segregated in compliance with federal and other regulations	17,699	16,125
Securities on deposit in compliance with federal and other regulations, at market value	132,106	130,442
Total cash and securities on deposit	233,874	234,973
Receivables:		
Brokers and dealers	192,176	165,207
Customers (less allowance for doubtful accounts of $10,622 in 1977 and $13,528 in 1976)	2,908,989	2,363,833
Securities purchased under agreements to resell	1,156,477	932,493
Other	176,652	101,982
Total receivables	4,434,294	3,563,515
Securities inventory, at market value:		
Bankers' acceptances, certificates of deposit and commercial paper	580,810	870,342
U.S. and Canadian governments	1,927,010	1,350,763
States and municipalities	210,891	135,318
Corporates	364,988	246,559
Total securities inventory	3,083,699	2,602,982

appendix C ***(concluded)***

	1977	1976
Other:		
Investment securities, principally bonds, at amortized cost (market value, $53,869 in 1977 and $41,837 in 1976)	55,524	41,653
Office equipment and installations (less accumulated depreciation and amortization of $57,444 in 1977 and $49,548 in 1976)	92,409	74,337
Residential properties under contract	74,179	—
Deferred properties policy acquisition costs	44,513	37,330
Other assets	76,107	60,797
Total other	342,732	214,117
Total	$8,094,599	$6,615,587
Liabilities and shareholders' equity		
Loans:		
Bank loans	$1,926,278	$1,757,841
Commercial paper	632,878	393,797
Borrowing agreements with institutions	78,800	—
Securities sold under agreements to repurchase	2,176,604	1,603,785
Intermediate-term loans	102,500	—
Total loans	4,917,060	3,755,423
Payables and accrued liabilities:		
Brokers and dealers	373,153	341,748
Customers	1,088,782	927,614
Drafts payable	238,022	206,976
Insurance policy benefits	33,456	30,268
Income taxes	53,811	61,848
Employee Compensation and benefits	75,000	78,688
Other	214,256	156,013
Total payables and accrued liabilities	2,077,480	1,803,155
Commitments for securities sold but not yet purchased, at market value:		
U.S. and Canadian governments	317,894	341,421
Other	136,298	83,516
Total commitments	454,192	424,937
Shareholders' equity:		
Common stock, par value $1.33⅓ per share—authorized 60 million shares; issued 36,140,179 shares	48,187	48,187
Paid-in capital	81,627	87,185
Retained earnings	532,329	518,597
Total shareholders' equity	662,143	653,969
Less common stock in treasury, at cost—777,687 shares in 1977 and 982,569 shares in 1976	16,276	21,897
Total shareholders' equity less common stock	645,867	632,072
Total liabilities and shareholders' equity	$8,094,599	$6,615,587

Source: Merrill Lynch & Co., Inc. 1977 annual report, pp. 8, 9.

appendix D

Statement of Consolidated Earnings
Years Ended December 30, 1977, and December 31, 1976
($000 except per share amounts)

	1977 (52 weeks)	*1976 (53 weeks)*
Revenues:		
Commissions	$ 366,138	$ 442,947
Interest	353,784	237,857
Principal transactions	188,464	261,285
Investment banking	120,091	115,295
Insurance	44,650	34,358
Other	51,089	33,187
Total revenues	1,124,216	1,124,929
Expenses:		
Employee compensation and benefits	436,079	431,029
Interest	312,769	202,703
Occupancy expense and equipment rental	70,375	64,459
Communications	60,516	54,684
Brokerage, clearing, and exchange fees	36,436	38,476
Advertising and market development	33,557	26,039
Office supplies and postage	24,268	21,953
Insurance policyholder benefits	15,532	14,517
Other operating expenses	63,402	64,616
Total expenses	1,052,934	918,476
Earnings before income taxes	71,282	206,453
Income taxes	27,335	99,845
Net earnings	$ 43,947	$ 106,608
Net earnings per common share	$ 1.25	$ 3.01

Source: Merrill Lynch & Co., Inc. 1977 annual report, p. 7.

appendix E

Five-year financial summary ($000, except per share amounts)

	Year ended last Friday in December										Compound growth rate, percent (1973–77)
	1977 (52 weeks)		1976 (53 weeks)		1975 (52 weeks)		1974 (52 weeks)		1973 (52 weeks)		
Revenues											
Commissions:											
Listed securities	$ 257,037	22.8%	$ 319,882	28.5%	$ 313,827	32.1%	$ 236,052	29.5%	$ 273,498	36.0%	(1.5%)
Options	44,977	4.0	59,948	5.3	38,891	4.0	8,681	1.1	2,279	0.3	110.8
Over-the-counter securities	16,831	1.5	17,883	1.6	11,796	1.2	8,259	1.0	13,117	1.7	6.4
Mutual funds	2,610	0.2	2,185	0.2	2,848	0.3	4,556	0.6	25,012	3.3	(43.2)
Commodities	44,683	4.0	43,049	3.8	37,408	3.8	34,572	4.3	42,739	5.6	1.1
Total commission revenues	366,138	32.5	442,947	39.4	404,770	41.4	292,120	36.5	356,645	46.9	0.7
Interest:											
Margin balances	145,895	13.0	112,896	10.0	99,551	10.2	141,220	17.6	141,916	18.7	0.7
Securities owned and deposits	207,889	18.5	124,961	11.1	105,824	10.8	89,501	11.2	44,442	5.8	47.1
Total interest revenues	353,784	31.5	237,857	21.1	205,375	21.0	230,721	28.8	186,358	24.5	17.4%
Principal transactions:											
Government and agency securities	56,693	5.0	122,968	10.9	93,023	9.5	78,048	9.8	45,780	6.0	5.5
Municipal securities	21,075	1.9	29,428	2.6	23,638	2.4	14,961	1.9	11,666	1.5	15.9
Corporate securities	96,067	8.6	90,510	8.0	49,421	5.0	41,944	5.2	39,201	5.2	25.1
Money market securities	14,629	1.3	18,379	1.7	21,178	2.2	23,557	2.9	8,955	1.2	13.0
Total principal transaction revenues	188,464	16.8	261,285	23.2	187,260	19.1	158,510	19.8	105,602	13.9	15.6
Investment banking:											
Underwriting fees	47,366	4.2	39,298	3.5	44,583	4.5	23,738	3.0	22,741	3.0	20.1
Selling concessions	72,725	6.5	75,997	6.8	80,984	8.3	44,280	5.5	35,237	4.6	19.9
Total investment banking revenues	120,091	10.7	115,295	10.3	125,567	12.8	68,018	8.5	57,978	7.6	20.0
Insurance:											
Life	32,593	2.9	27,222	2.4	23,505	2.4	20,674	2.6	18,252	2.4	15.6
Accident and sickness	7,028	0.6	7,077	0.6	7,299	0.7	7,374	0.9	6,933	0.9	0.3
Other	5,029	0.5	59	—	31	—	—	—	—	—	—
Total insurance revenues	44,650	4.0	34,358	3.0	30,835	3.1	28,048	3.5	25,185	3.3	15.4
Other revenues	51,089	4.5	33,187	3.0	25,446	2.6	23,212	2.9	28,361	3.8	15.9
Total revenues	1,124,216	100.0	1,124,929	100.0	979,253	100.0	800,629	100.0	760,129	100.0	10.3

Expenses											
Employee compensation and benefits	436,079	41.4%	431,029	46.9%	370,170	47.3%	308,430	42.3%	312,572	45.4	8.7
Interest	312,769	29.7	202,703	22.1	158,585	20.3	194,029	26.6	148,553	21.6	20.5
Occupancy expense and equipment rental	70,375	6.7	64,459	7.0	60,828	7.8	57,980	7.9	55,840	8.1	5.9
Communications	60,516	5.7	54,684	6.0	45,694	5.8	41,491	5.7	41,418	6.0	9.9
Brokerage, clearing, and exchange fees	36,436	3.5	38,476	4.2	33,969	4.3	26,752	3.6	29,941	4.3	5.0
Advertising and market development	33,557	3.2	26,039	2.8	21,674	2.8	17,481	2.4	19,451	2.8	14.6
Office supplies and postage	24,268	2.3	21,953	2.4	17,799	2.3	15,730	2.2	14,251	2.1	14.2
Insurance policyholder benefits	15,532	1.5	14,517	1.6	13,927	1.8	12,916	1.8	11,434	1.7	8.0
Other operating expenses	63,402	6.0	64,616	7.0	59,575	7.6	54,419	7.5	55,020	8.0	3.6
Total expenses	1,052,934	100.0%	918,476	100.0%	782,221	100.0%	729,228	100.0%	688,480	100.0%	11.2
Earnings before income taxes	71,282		206,453		197,032		71,401		71,649		(0.1)
Income taxes	27,335		99,845		101,341		33,866		34,921		(5.9)
Net earnings	43,947		106,608		95,691		37,535		36,728		4.6
Preferred dividend requirement	—		—		5		202		202		—
Net earnings applicable to common stock	43,947		106,608		95,686		37,333		36,526		4.7
Average number of common shares outstanding	35,147,074		35,389,834		35,596,107		35,917,361		35,738,835		
Net earnings as a percent of revenues	3.9%		9.5%		9.8%		4.7%		4.8%		
Per common share data:											
Net earnings	$ 1.25		$ 3.01		$ 2.69		$ 1.04		$ 1.02		5.2
Cash dividends declared	.86		.80		.59		.56		.56		11.3
Shareholders' equity	18.26		17.98		15.95		13.92		13.45		7.9
Balance sheet data (at year end):											
Total assets	$8,094,599		$6,615,587		$4,879,012		$4,124,554		$3,815,571		
Shareholders' equity	645,867		632,072		567,417		506,002		486,775		
Return on average shareholders' equity	6.9%		17.8%		17.8%		7.6%		7.7%		

Source: Merrill Lynch & Co., Inc. 1977 annual report, p. 6.

case 18

KSM/Beefalo Breeding Company: Entrepreneurial strategies in diversified markets

1 "It seems that every week brings a new dimension to our business," mused George Schweiger, president of KSM Enterprises. "I wonder where we will be a year from now?" Schweiger sat reflectively at his desk gazing out the window of the log home that served as the sales office for the Beaver Log Home distributorship that KSM acquired late in the summer of 1977. He was looking across a snow-covered pasture toward the barns and livestock pens of the Clarence Korte farm. It was on this Illinois farm that Schweiger and Korte launched the Beefalo Breeding Company in April 1977 with the importation of 40 head of half-blood beefalo from California. After less than a year of operation in their two businesses, the management team of Schweiger and Korte were considering diversification into yet another distinct enterprise—fast-food restaurants.

Events leading to the new businesses

2 The business experience of George Schweiger, which spans 30 years, has been primarily that of a salesman, promoter, and entrepreneur. For 13 years he was in the insurance business, for 7 years in the construction business, part of which involved site location/acquisition, contractor negotiations, and equipment installations for the Bonanza Steak House chain of restaurants in the Seattle region. About 11 years ago he relocated in Illinois as the national marketing director for a new firm specializing in outdoor lighting systems. From this position he spun off a new firm involved in custom plastic packaging. Eventually this enterprise diversified toward end products by manufacturing nonprescription pharmaceuticals and cosmetics. Schweiger's function in the above two businesses was in *sales management*. Five years ago he switched into brokerage consulting, specializing in diamonds and bulk Scotch whiskey. After two years in the brokerage business he organized a company to develop an organic fertilizer produced from a bacteria blend of decomposing sawdust. It was through this agricultural venture that he developed a working relationship with Clarence Korte, an experienced organic farmer and dairy rancher.

3 Clarence Korte, after retiring from military service in 1956, joined his brother Ralph to start the Korte Construction Company. Currently this con-

This case was prepared by Curtis W. Cook of Southern Illinois University at Edwardsville.

struction firm is one of the largest in southern Illinois with several multimillion dollar contracts for industrial and commercial buildings. However in 1962 Clarence decided to leave management involvement in Korte Construction and return to his family's tradition in farming. In partnership with his brother, Clarence developed a large Holstein dairy herd and converted to all-organic farming on the 520-acre farm near Pocahantas, about 40 miles east of St. Louis. In November 1976 fire destroyed most of the physical plant of the dairy operation causing an estimated $350,000 loss. Rather than rebuild for dairy production, the Kortes liquidated all dairy assets in February 1977. Clarence was intrigued by the economic and nutritional superiorities of beefalo (a bison-bovine hybrid) over conventional beef cattle. In conjunction with George Schweiger, the Kortes decided to venture into this new breed of livestock. Thus, Beefalo Breeding Company was formed as the start of a herd buildup began in spring of 1977.

4 While the calamity of a fire provided the circumstances that cleared the way for entry into beefalo production, the log home business began more as a marketing outgrowth of another product line sold through KSM Enterprises. KSM was also established in 1977 when Schweiger, who has a penchant for novel products, brought to the new firm the distributorship for a European-produced, low-temperature radiant heating system. The product is a system conductive foil sealed in sheet plastic that is stapled to ceiling framing prior to installation of drywall, plasterboard, or acoustical tile. Out of a desire to have a means of displaying and demonstrating the product, the possibility of selling and/or constructing homes was considered. Management quickly narrowed the search to becoming a distributor for some manufacturer of precut log homes, and Beaver Log Homes of Grand Island, Nebraska, was selected.

5 Thus, by the end of their first year of investment/management association, Schweiger and Korte had established their two principal businesses as log home sales and beefalo breeding/production. Yet serious challenges remained as to the desired direction and rate of future growth, with capital availability a chronic constraint.

Managerial roles

6 In seeking to define alternatives relative to these challenges, the two principals in these joint enterprises have informally evolved specialized roles. Clarence Korte, with experience in construction and livestock/farming management, concentrates on production-related tasks. This involves not only management of the livestock operation but also supervision of erecting log structures and constructing whatever finishing touches are desired by the purchaser of a log home or barn.

7 George Schweiger tends to the sales and financial side of the business. Included in his role are direct selling/merchandising of both log homes and beefalo as well as promoting investments in beefalo under a variety of tax-

sheltered programs. Schweiger acknowledges that he is a dreamer and promoter of ideas and novel concepts:

> Probably the greatest problem I have is going from one thing to another. I am looking for the new products, the different ideas. I have always maintained that talent is the cheapest commodity that can be obtained. Sure, good talent is expensive, but in relationship to its performance it is a value. My feeling has always been that if I can get it together, so to speak, then I'll find somebody else more qualified than I to manage it. . . . So I tend to be a dreamer. If a potential product is there, it can be made to work given the proper infusion of capital and management expertise. If I have any expertise at all, I think it is in the field of taking ideas and converting them into different types of presentations for development of a business.

KSM Enterprises and the Beaver Log Home contract

8 KSM Enterprises, Inc., was incorporated on March 1, 1977, with 300,000 no par shares authorized (although franchise taxes were paid on only 100,000 shares). An initial equity capitalization of approximately $87,000 was obtained with investments from Korte equal to 29.2 percent of the total, Schweiger with 26.5 percent, one silent investor with 32 percent, and six others totaling 12.3 percent. As of December 31, 1977, book value was 87 cents per share. During its formative period, KSM relied on borrowed funds to provide partial financing of physical facilities and periodically to supply working capital. One year from date of incorporation, debt financing totaled approximately $35,000.

9 Schweiger brought to KSM the radiant heating system with which he had been involved for about eight months prior to incorporation. In deciding to expand the product line to include the home in which the heating system could be installed, he did not want the newly established KSM to compete directly with more experienced companies. Speaking in February 1978, Schweiger explained:

> We just didn't want to go out and start building stick-built homes so we started to explore the log home market and found that everything indicated that it was probably the fastest growing segment of the building market. We felt that there was an opportunity here. Three years ago, there probably wasn't a log home—other than Abe Lincoln's cabin up at Salem—within a 50-mile radius of here. Today there are probably a dozen.

10 With a determination to enter into a distinctly different segment of the construction industry, after researching the product, production methods, and financial capabilities of 15 log home manufacturers, management decided to negotiate with Beaver Log Homes. When asked why Beaver Log Homes was selected over other manufacturers, Schweiger stated:

> Principally, because our studies of other companies indicated to us that both from the standpoint of the finished product as well as the overall

> financial strength and capabilities of the firm, Beaver offered to us and to the consumer the best log home on the market today for the price. There is a superior log home to Beaver, cut from Michigan White Cedar, but it is not the home for the average buyer. So we just felt that Beaver was by far the best company to deal with.

11 The contract gave KSM dealership rights to all of southern Illinois, including the right for KSM to contract for subdealers in communities throughout that part of the state. One contract provision required KSM to build either a log home or log office building to serve as a demonstration model. Since the Korte farmland was adjacent to I-70 (a major interstate connecting the St. Louis metropolitan region to points east), management decided to errect a log office facility adjacent to the interstate where it would be clearly visible from both directions, even though exits and the closest commercial activities are approximately two miles from the site. The nearest community with light industrial firms is Highland, about five miles to the southwest.

12 Under terms of the contract with Beaver, KSM will receive a 27.5 percent discount from list price if they equal or exceed the purchase of 50,000 lineal feet of logs annually. Additionally, quarterly quotas are to be met or the margin will be reduced. For each quarter that quotas are met, an additional 2 percent production bonus (beyond 27.5 percent) is awarded.

Marketing of log homes

13 Beaver sells log homes principally on the basis of logs precut for several types of basic floor plans, both one- and two-story homes. The design of an average-sized Beaver Log Home requiring 2,359 lineal feet of logs, suggested retail price for logs about $8,300. Custom design is possible as log construction is not limited to size or shape of floor design, although height is limited without cross-tie structural support. Clarence Korte, for example, built and custom designed a 3,100-square-foot home for his family. Logs are cut and number coded (to match blueprint designs) at the mill in Claremore, Oklahoma and transported directly by truck to the building site.

14 KSM sells on a cash basis with 30 percent down payment required either from the individual purchaser or the subdealer at the time the contract is signed. The remainer is due at the time logs are delivered. KSM will help prospective customers work with local banks or S&Ls to arrange mortgage financing. For individuals purchasing within about a 100-mile radius of Highland, Illinois, KSM will erect the log home shell on the owner's foundation if the owner/builder so desires. Clarence Korte assembles and supervises a crew of laborers for this purpose on an as-needed basis. KSM will also provide whatever finishing the customer desires. Once a contract is signed, the normal delivery schedule is 45 days for delivery, with 15 days variance according to the mill's cutting schedule.

15 KSM engages in little newspaper advertising. The parent does advertise

in some trade magazines and popular home-related magazines (i.e., *Better Homes and Gardens*). KSM primarily relies on local home shows as a means of achieving exposure and creating interest. For such purposes, an 8-foot by 10-foot display booth (constructed of Beaver logs) is erected at the show site. The principal costs of such promotional activity is the show promotional fee and the labor cost of someone to work at the booth distributing free brochures, talking to those who pass by, and selling to interested parties a $3 book of Beaver plans and specifications for standard model homes. Promotional fees are for advertising of the home show, typically for radio spots which might run from $280–$560 for 40 to 120 spots that promote both the show and the sponsorer (in this case KSM's Beaver Homes).

16 Because of the vastness of the franchised sales territory, KSM management intends to sell primarily through contracts with builders/dealers who represent one to three county areas. KSM will discount logs to subdealers or contract builders from 5 percent to 22.5 percent off list price, depending on expected sales volume of the dealer. Such a practice would reduce the pressures on Schweiger to personally be responsible for direct selling to individual home owners.

17 For KSM to qualify for the 27.5 percent operating margin discount, approximately 24 average-size homes of 2,050 lineal feet need to be sold annually with about 20 per year necessary to break even. Such an average size (based on Beaver sales statistics) represents a value of $7–8,000 each. Logs represent 18–25 percent of the total cost of the house, with 20 percent considered a rule of thumb. Other cost factors include foundation or basement, plumbing, heating systems, electrical, doors and windows, and so on.

18 After the first six months of the Beaver dealership, KSM had sold three homes. By February 1979 (after 1½ years), a total of 18 log buildings had been sold, and bids were out on 15 additional plans.

Beefalo as a new meat source

19 Beefalo are a hybrid bison/bovine cross-developed to impart the growth advantages of bison (buffalo) into meat production animals that would have color, confirmation (shape), and edible characteristics similar to beef cattle. A successful breed was first announced in 1973 by developer D. C. "Bud" Basolo, after years of experimentation and breeding up to arrive at a pureblood sire. A pureblood beefalo is defined as three eighths American Bison and five eights domestic bovine (typically three eighths Charolais and two-eights Herford). Several production advantages are claimed for beefalo over beef.

20 1. Beefalo calves are smaller at birth (approximately 45–65 pounds compared to 80–105 pounds for cattle). Thus, less assistance and care are necessary at birth resulting in lower losses (deaths), especially on open ranges.

21 2. Beefalo are believed heartier than cattle, able to withstand greater temperature extremes and less prone to sickness. Historically buffalo herds roamed from Canada to Mexico and prior to man, their principal adversary was the predator (wolves, coyotes, etc.). Calves are able to run approximately four hours after birth regardless of weather conditions.

22 3. Beefalo mature more quickly than beef. Animals mature to a slaughter weight (approximately 1,000–1,100 pounds) in about 12 months compared to about 18 months for beef.

23 4. Beefalo convert feed to flesh more efficiently than beef and require less grain for finishing. A test conducted by Dr. Gary C. Smith at Texas A&M University in 1976 statistically confirmed the superior productive efficiency of 486 head of beefalo compared to bovine control groups. Among some of Dr. Smith's findings, one pen of cattle on a feed ration of 14 percent roughage and 86 percent concentrate (corn, rolled oats, soy meal, etc.), over a 120-day period for finishing prior to slaughter, gained an average 2.55 pounds per day at a feed cost of 47 cents per pound. Beefalo which were on a 26 percent roughage ration averaged a gain of 2.71 pounds per day at the same 47 cents cost. Those beefalo on a 36 percent roughage produced an average daily gain of .5 to .7 of a pound more (3.21 to 3.41) at a cost of 37 cents per pound.

24 5. Beefalo yield a proportionately higher percentage of meat to live weight. This results from more energy being converted into muscle tissue rather than fat. In the A&M study, all beefalo carcasses were federally graded in yield grade 2, the most favored yield grade of producers since excess fat is minimal yet the meat tissue is bright in color and well conformed (blocky rather than thin and rangy). As a percentage of dressed carcass to live weight, the beefalo averaged 63 percent compared to a typical 59–61 percent yield for steers or English bred cattle. Dr. Smith commented, "Based on my experience of 15 years work in this field, they (beefalo) have remarkable dressing percentages and it is due to the fact that they are muscular, extremely muscular in relation to other cattle."

25 Considered as food for human consumption, beefalo test out favorably in terms of nutritional value relative to beef. The following data from Certified Labs Inc., 19 Hudson St., New York (USDA Certified Laboratory #3677) are representative of comparative analysis of beefalo (ground) and ground beef as purchased in supermarkets:

	Lot Dec 484 ground beefalo	*Lot Dec 483 ground beef*
Protein	20.35%	16.67%
Fat	3.65%	24.80%
Calories	32.4/ounce	82.4/ounce
Cholesterol	5.19 mg./ounce	150.5 mg./ounce

Beefalo Breeding Company's production operations

26 Within one year of their inception, Beefalo Breeding Company developed the largest herd of beefalo in the Midwest. Most of the 520 acres on the Korte brothers farm are devoted to organic farming of feed grains for feed fattening and finishing of livestock. Since 1970 the farm has been entirely organic, eliminating the use of chemical fertilizers, herbicides, and pesticides. The farm carries organic certification and is one of two selected by Dr. Barry Commoner of Washington University for comparative studies between chemical and ecological farming. This farm has a capacity for producing grain and alfalfa capable of finishing approximately 800 head per year on the basis of a quarterly turnover (90-day finishing). The Korte farm itself is not intended for extensive grazing, as all but about 65 acres is cultivated farmland. Currently there are four grain storage tanks adjacent to the feedlot, each capable of holding approximately 65 tons of feed.

27 The company is incorporated separate from KSM with Schweiger and the Korte brothers as the stockholders. It is a member of both the World Beefalo Association (California) and the American Beefalo Association (Kentucky), organizations concerned with registering breeders and developing performance data on the various beefalo blood lines. Beefalo Breeding Company is under a management/feeding contract with the Korte farm for the feeding and care of the herd. Under terms of the arrangement, the corporation pays Korte 27.5 cents per pound of weight gain which provides an adequate return to the Korte farm. If Holsteins or Herefords were being fattened instead of beefalo, a fee of at least 35 cents per pound would be necessary for the farm to obtain a similar return. This difference is because of the genetic advantage of beefalo which have the same digestive track as buffalo, a more efficient converter of feed.

28 Beefalo Breeding Company prefers to place 800- to 850-pound beefalo (after grass feeding) into the feedlot for 60–90 days. A 12- to 15-bushel hot feed ration (of rolled oats, corn, crushed wheat, soy meal, etc.) will produce white marbeling and exterior fat suitable to yield a choice quality grade (the most-used grade in major supermarkets) and a quantity-yield grade of 2.

29 To accommodate grassland feeding, Beefalo Breeding Company bought a 670-acre ranch located in south-central Missouri, near Salem (valued at $300,000). The 540 acres of pasture land in this ranch, once improved, will be capable of supporting a 300–350 head beefalo cow-calf operation. While the first year of business saw a buildup to 135 animals at the Illinois facility, in April 1978, the first 124 head were delivered to the Missouri ranch. This herd was purchased from a breeder in Pauls Valley, Oklahoma, at a cost of $38,000 delivered, financed through an open-end bank note.

Marketing beefalo

30 While beefalo is subject to the same grading process as beef, in February 1978, the meat division of the USDA issued basic guidelines to their field

graders that would certify beefalo as a separate class of animals from beef. Having this classification enables beefalo to be marketed as distinct from beef, although in practice it can be sold through supermarkets as beef since the consumer would not discern the difference.

31 Since beefalo are a relatively new breed of livestock, on a national basis herd sizes remain small. To build up herds, most breeders retain heifers for calf production and sell off as slaughter animals young bulls/bullocks (most breeding is through artificial insemination from registered pureblood bulls). This scarcity of slaughter animals enables beefalo producers generally to command a premium price for their meat, usually about 10 cents per pound over comparable beef carcass grades. Organically produced and certified meat of any kind also usually commands a higher price because of presumed health advantages.

32 By late March 1978, Beefalo Breeding Company had 30 head ready for slaughter (1,100–1,200 pounds each), the first in any quantity for retail sale. At this time the Chicago Board of Trade price quote for choice beef was in the \$46–48 range, live weight basis. Schweiger and Korte both expressed disillusion with conventional meat distribution systems, since the producer essentially is a price taker. For this reason they explored alternative marketing approaches. Schweiger remarked:

> We are not in accord with the current marketing methods of the agricultural industry. We think they are controlled too much by speculators. If we can control our production cost and go directly to the consumer with the finished product, we can reap the profits currently enjoyed by the speculators as opposed to the producers.

33 Since Beefalo Breeding had not previously slaughtered more than one or two animals at a time, they had no regular clientele or distribution procedures. Several alternatives were thus explored. Schweiger phoned Nelson Name Service in Minneapolis to see if they could compile lists of all of the health food stores and Weight Watchers Clubs in Illinois. Packages of frozen select retail cuts (i.e., steaks, roasts, ground beefalo) could be sold to health food stores. To Weight Watchers the intent would be to sell halves or quarters of beefalo, either in fresh carcass form or cut and frozen. Beefalo Breeding Company also was contacted by a New York beefalo firm asking if it would be possible to purchase slaughter-ready livestock. Although the New York firm was smaller in actual numbers of beefalo, they had an established promotional and distribution system (selling direct to consumers in halves and quarters).

34 Schweiger also contacted area supermarket chains to explore the feasibility of a special beefalo promotion. In talking with the manager of meat operations with the National Supermarket chain (which had a large share of market in the St. Louis area), the idea was readily acceptable. However, to be able to use beefalo as a promotional item, National would require at least 300 head since they followed a policy of uniform advertising within a metropolitan market.

35 Another option was to have approximately 80 percent of the carcass ground into hamburger patties to build up a supply pending the opening of Beefalo Barns restaurants (details noted in future section). The remaining 20 percent (steaks only) would be packaged in 10-pound units, frozen, and sold through local promotion.

36 However, because these animals had to go to slaughter (additional feeding would result in minimal salable weight gain), Schweiger in April made arrangements to supply five IGA markets (local independents) in Peoria, Illinois, with 14 head for a special sale. The price was 10 cents per pound dressed weight over choice beef. Additionally, in a reciprocal arrangement with a Springfield, Illinois radio station, Beefalo Breeding Company sold livestock directly to a Springfield packer with the radio station advertising the availability of beefalo halves and quarters. The advertising was at no direct cost to the company since Clarence Korte had supplied an electrical power generator to the radio station when an ice storm in late March knocked out their power source and forced them off the air. Schweiger saw these market sources more as temporary, although he recognized residual value in (*a*) exposing the public to beefalo, (*b*) possibly attracting some wealthy investors into tax-sheltered partnerships of herds under management contract to Beefalo Breeding Company, or (*c*) attracting potential investors to the fast-foods concept of Beefalo Barns.

The need for outside capital

37 While developing markets (at a premium price) for fattened livestock consumed part of Schweiger's time, most of his energy during 1978 was devoted to developing a variety of prospecti for attracting equity investors or debt capital. Additional capital was desired for three purposes: (*a*) to build up herd size to fully utilize the feedlot capacity and/or provide adequate meat supply for six restaurants, (*b*) to launch a fast-food restaurant operation through general partnerships, franchising, and/or stock placement, and (*c*) to lease and/or purchase additional pasture land where beefalo would graze until reaching an appropriate feedlot weight.

38 Schweiger worked with two firms that might be able to attract investors interested in the tax-sheltering prospects of livestock. He held several meetings during 1978 with the St. Louis office senior tax partner of Pete, Marwick, and Mitchell and with a principal in the Investment Planning Group of Clayton, Missouri. The intent of working with these firms was to pull together a group of investors with sufficient capital for one or more large herds of beefalo. Schweiger explained the basics of one of his proposals:

> If we had a 100 per herd, we would sell an absentee owner group the animals and manage the herd under the contract. With this arrangement we would not need anyone's money (for working capital). We would have all our own. The basic annual fee would be $350 per year per cow. There would be a $300 maintenance cost on the cow plus a $50 breeding fee. We would

maintain the cow with her calf until the calf was weaned, and then prorate the remaining number of months (to anniversary date of contract) against the $300 maintenance fee for the offspring. We would assume all feeding costs and charge outside veternarian fees. If the investing group wanted insurance, it would be their responsibility. The annual management-maintenance fees would be paid in advance.

A 100-head partnership program would require a total capital investment of $204,000. If we had one partner in a 40–50 percent tax bracket, let's say with a 5 percent participation, he would initially invest $10,200. In the first year he would write off 85 percent of his capital contribution against his income tax (for paper losses since there is no revenue inflow). In the second year against his cash contribution he will write off 188 percent against his taxes, the fourth year 444 percent, and from the fourth year on the partnership is actually in an income-producing position. But from an investor's viewpoint, the front-end years provide a tremendous write-off against personal income tax. The net result of a seven-year program, based on current prices of animals, would be a net cash accumulation in excess of $2 million if the herd is liquidated. Although programmed to terminate at the end of the seventh year, in reality there would be no good reason to liquidate unless the limited partners wanted their capital to invest in another program that would have an accelerated depreciation schedule.

39 Finding it difficult to put together tax-sheltered partnerships in the magnitude mentioned above, Schweiger toward year-end 1978 began promoting smaller programs, based on a minimum of 10 head. Such programs would involve a first-year cash outlay of approximately $11,000 for 10 heifers (female) beefalo. This proposal included many of the features of previous ones (i.e., describing beefalo, the principle of breeding up, advantages of starting with half-blood heifers, risk factors, and management), although in less detail. Exhibits 1A–1D present some of the agreement forms and financial projections for this type of program.

The Beefalo Barns (fast-food) concept

40 Most of the conventional marketing alternatives available to Beefalo Breeding Company represent variations of the beef distribution system. The company is committed to breed and produce beefalo, but seeks a market outlet that preserves the identity of beefalo and provides a premium price. When asked if his proposed development of a new fast-food chain was viewed as a means of controlling disposition of the end product, Schweiger responded:

No, I see the restaurant alternative as a completely separate program with beefalo and catalyst for a restaurant chain—for a franchised chain—as opposed to setting up one or two restaurants just to get into the restaurant business. The ultimate limitation with the restaurant concept is that it cannot enjoy the accelerated growth that potentially might be there because there simply are not the animals to support it. This year we wouldn't assemble more than 50,000 head of beefalo even if we contacted every breeder in

exhibit 1–A
Sample pages of tax-shelter beefalo proposal

BEEFALO PURCHASE AGREEMENT

THIS AGREEMENT made and entered into on the __________________ day of __________________ 197___, by and between Clarence A. Korte and George D. Schweiger, d/b/a Beefalo Breeding Company, (Seller) R.R. #1, Pocahontas, Illinois, 62275, and ____________________________________

(''Buyer'') whose mailing address is __________________________________

____

WITNESSETH:
In consideration of the mutual covenants, terms and conditions contained herein, the parties hereto do hereby agree as follows:

1. Seller agrees to sell to Buyer __________ head of one-half (½) blood registered Beefalo Breeding cattle (hereinafter referred to as the Breeding Herd) which animals are more particularly described in Exhibit A attached hereto and made a part hereof. All animals purchased shall be subject to the approval of Buyer at the time of delivery.

2. Buyer and Seller are entering into a certain Management and Marketing Agreement of even date herewith, relating to the management, maintenance and breeding of the Breeding Herd and all progeny resulting therefrom.

3. The animals in the Breeding Herd are represented and warranted to be breeders capable of being registered in either or both the World Beefalo Association (WBA) or the American Beefalo Association (ABA) and, at the option of Buyer shall be registered in the association elected by Buyer.

4. Seller shall successfully breed each female in the Breeding Herd with semen from a pureblood Beefalo bull, should any animal fail, after a reasonable time to settle, Seller shall replace it with a comparable animal. Any replacement or substitution of animals in the Breeding Herd shall carry the same warrantees as setforth herein.

5. Buyers agrees to pay a total purchase price of one thousand five hundred ($1,500), dollars for each female in the Breeding Herd for a total purchase price of

$____________________________.

a. The sum of six hundred ($600), dollars per female in the Breeding Herd shall be paid on the date hereof;

b. The balance of nine hundred ($900), dollars per female in the Breeding Herd shall be paid on or before January 1, 197___, provided, however, that Buyer

the country. But we can put together a sufficient number of animals to supply six restaurants over the next 12–18 months.

41 The concept that Schweiger began exploring early in 1978 was to develop distinctiveness in fast foods both through product and building design. His idea was to extend the log home concept into a restaurant building structure constructed of Beaver logs. The menu would feature beefalo burgers in several sizes as a means of achieving product differentiation. The integration

exhibit 1-A ***(concluded)***

may have the option, in lieu of making such payment, to execute and deliver to Seller a Promissary Note in the form attached hereto as Exhibit ______ in the principal amount of such balance. The Promissary Note, until the balance of the purchase price is paid, shall accrue interest at the rate of nine (9%) percent per annum, and such principal shall be paid upon the earlier of:

(1) Sale, with the consent of Buyer, of female animals (except culls) from Buyers herd which are the animals purchased hereunder or their progeny (or sale of any animals in liquidation of the herd), such payment to be limited to the proceeds of such sale.

(2) Seven years from date of the execution hereof.

6. The outstanding balance of principal and interest thereon shall be secured by a security interest in all animals purchased hereunder and their progeny. Buyer agrees to execute from time to time such Financing Statements or other documents as Seller may request to perfect such security interest in the State of Illinois, Missouri and elsewhere; including, without limitation, any Uniform Commercial Code Financing Statements or renewals thereof. Buyer appoints Seller as Buyer's attorney-in-fact to execute and file any such documents.

7. In the event Seller shall default under the Management and Marketing Agreement and as a result of such default Buyer as Owner terminates said Agreement, Buyer shall nevertheless remain obligated to satisfy the Note.

8. In the event that Buyer terminates this Agreement during the first three calendar years, he will pay to the Company 50% of the progeny value as additional fees. Determination of the value of the progeny shall be made by an independent third party selected and mutually agreed upon by both parties hereto.

9. All representations, conditions, warranties and agreements setforth herein shall survive delivery of title and Buyer acknowledges that there have been no representations, expressed or implied except as setforth herein.

10. This Purchase Agreement, the Management and Marketing Agreement, the Security Agreement and the Note constitute the entire understanding between the parties hereto with respect to the subject matter hereof. Any changes, amendments or deletions must be in writing and signed by the parties to this Agreement.

This Agreement shall be interpreted in accordance with the laws of the State of Illinois.

IN WITNESS WHEREOF the parties have set their hands and seals this ____________ day of ______________ 197______.

Buyer ________________________ Seller ________________________

of the product and the structure would build promotion and furnishings around a western theme. Schweiger did not, however, foresee thrusting a marketing appeal to specific segments, such as the health-conscious consumer. He commented, "Anyone who stops at a fast-food restaurant is a market for us. We're not after only the teenage market, the older age market, the afterhours disco crowd, or anything like that." However he later noted that the health aspects of beefalo might be a major selling point. "This is the

exhibit 1-B

MANAGEMENT AND MARKETING AGREEMENT

THIS AGREEMENT is made and entered into on this ________ day of ____________________ 197 ______, by and between Clarence A. Korte and George D. Schweiger, d/b/a Beefalo Breeding Company, hereinafter referred to as Company and ____

whose mailing address is ______________________________________

__________ hereinafter referred to as "Owner."

WITNESSETH:

WHEREAS, Owner is the sole owner and operator of the Beefalo breeding livestock, hereinafter referred to as "livestock" or "animals" described in Exhibit A, which is attached hereto and made a part hereof, and,

WHEREAS, The Company is presently operating Beefalo breeding ranches in Illinois and Missouri and is experienced in the breeding management and marketing of Beefalo livestock, and,

WHEREAS, Owner desires Company to manage, breed and sell said Livestock under the terms and conditions of this Management and Marketing Agreement.

NOW THEREFORE in consideration of the mutual promises and covenants contained herein, the parties agree as follows/

1. Owner represents that he is the sole owner of the Livestock (Exh. A), subject only to the terms of the Beefalo Purchase Agreement, and a promissory note and Security Agreement referred to therein.

2. Company shall provide all management and shall maintain, care for, feed and take whatever other steps are reasonably necessary for the well-being of the Livestock and their progeny. The maintenance of the Livestock under this Agreement shall include the breeding, feeding, calving, normal veterinarian services, raising and growing out of progeny, and the keeping of breeding and identification records in connection with the Livestock. Company agrees to maintain, care for and breed the Livestock in accordance with the standard practices for a purebred Beefalo operation and in accordance with the instruction of Owner.

3. Company shall furnish owners semiannual reports regarding the status of the Livestock subject to this Agreement. In addition Company will furnish Owner, as soon as reasonably possible, data concerning any accident, illness or sickness causing the death of any of the Livestock, and a postmortem report with regard to such animal.

4. At the option of Owner and at Owner expense, Company will prepare applications for registration in Owners name of all progeny complying with the regulations covering said registration in either or both the World Beefalo Association (WBA) or the American Beefalo Association (ABA) and shall use its best efforts to obtain a lifetime membership in the Association of Owners choosing. Fees for membership in or the registration of progeny shall be paid by Owner and are not included in the fee due Company described in paragraph 8.

5. In order to assist Owner in its operation of its Livestock, Company shall be available periodically to consult with Owner in connection with the maintenance, care, and growth of the animals subject to this Agreement. Such advice and counsel shall be in connection with the general and special maintenance of the

exhibit 1-B ***(continued)***

Livestock, the sale of progeny, the retention of progeny, the selling, culling and replacement of Livestock in the Herd, and such other matters which are incident to the husbandry of Beefalo Livestock.

6. All Livestock subject to this Agreement shall be kept and maintained at such place or places as Company determines in its sole discretion, and during the term of this Agreement, Company shall, at all times, maintain control and jurisdiction over said animals; provided Company shall advise Owner of the location thereof and they shall be available for Owners inspection at reasonable times.

7. Company shall not be responsible or liable for any loss or damage to any of the Beefalo Livestock subject to this Agreement, on account of any accident, disease, or death, or by reason of any acts of any employee, servant, or agent of the Company, except in the event of gross negligence or willful misconduct by Company or its employees, servants or agents. However, Company shall have the right to replace or substitute any animal lost for any reason from the original Beefalo Breeding Herd, said replacement or substitution to be of comparable quality to animal(s) replaced or substituted.

8. In consideration of the Company's responsibilities, obligations and warranties hereunder, as a fee for the management of the Breeding Herd, Owner agrees to pay the Company as follows:

(1) The sum of four hundred ($400) dollars for each breeding female in the herd said sum payable upon the date first setforth above.

(2) The sum of four hundred ($400) dollars for each breeding female in the herd, said sum payable on the date of the first anniversary of this Agreement.

(3) The sum of four hundred ($400) dollars for each breeding female in the herd, said sum payable on the date of the second anniversary of this Agreement.

(4) In addition to the fees setforth above, [para. 8 one, two & three], the Company shall receive fifty (50%) percent of all net proceeds (gross sales less expenses) derived from the sale of any animals or other income from Owners Herd during the term of this Agreement and the Beefalo Purchase Agreement as full payment for management, maintenance, breeding and other services provided by the Company.

Company and Owner agree that the net proceeds realized from the sale of animals from the Herd, income from semen sales or other income, shall be distributed between the parties as setforth below:

a. Company shall receive fifty (50%) percent of all net income as provided in paragraph 8, Art. 4 above.

b. Owner shall receive fifty (50%) percent of all net income, provided, however, that from such amount Owner shall pay to Company any interest due on the Note for the current or prior years.

9. The Company may collect and sell semen obtained from bulls in the Owners Breeding Herd. Bulls and semen from Owners Breeding Herd may be used by Company on all cattle owned or managed by Company at no cost to Company.

10. This Management Agreement shall be effective commencing the date of execution and shall continue for a period of seven years from said date, provided however, that this Agreement shall be renewed at then prevailing rates being

exhibit 1-B ***(concluded)***

charged new Herd owners and, otherwise, on the same terms and conditions for one additional seven-year period from and after such termination date unless either party notifies the other, in writing prior to 90 days preceding the termination date, of its intent to terminate this Agreement. Notwithstanding the foregoing, Owner may at any time cancel this contract by 90 days' written notice to Company. Upon termination of this Agreement for any reason, all amounts owing to either party in accordance with the terms of this Agreement shall be paid on the same basis as if the Agreement were continued to the end of the quarter following the quarter in which notice is given. Owner shall be responsible for the removal of the Livestock from the place or places in which they are maintained as of the effective date of the termination, and as of such date Company shall have no further responsibilities in connection with such Livestock.

11. All notices required or permitted under the terms of this Agreement shall be delivered in person or by certified mail, postage prepaid, addressed as follows:

If to Company:

BEEFALO BREEDING COMPANY
R.R. 1
Pocahontas, Illinois 62275

If to Owner:

____

____

12. This Agreement shall be binding upon the parties hereto, their heirs, executors and administrators.

13. Any insurance with regard to the Livestock subject to this Agreement shall be paid by Owner, provided however, the Company shall use its best efforts to secure such coverage as requested by Owner.

14. The obligations of Owner under this Agreement are secured by a Security Agreement of even date herewith, and a default hereunder shall constitute a default under the Security Agreement.

15. Company shall not be required to advance any sums on behalf of Owner, but if it does, Owner shall repay the same promptly on demand and repayment thereof shall be secured by the security interest in the livestock.

16. Owner is fully aware of the speculative nature of purchasing and managing breeding cattle and represents that his or its financial circumstances are consistent with this investment and that he or it is a sophisticated investor and by reason of his or its business and financial experience, he or it has the capacity to protect his or its own interests in connection with his or its investment.

17. This Agreement constitutes the entire agreement of the parties hereto.

IN WITNESS WHEREOF, the parties hereto have set their hands on the date and year first above written.

OWNER (s) BEEFALO BREEDING COMPANY

By ____________________ By ____________________

exhibit 1-C
Three-year cash investment

Purchase of 10 beefalo breeding heifers:		
Down payment		$ 6,000.00
Management expense		4,000.00
Interest (prepaid)		810.00
Cash paid out 197__		$10,810.00
Tax effects:		
Depreciation (seven-year life—half year)	$2,142.90	
Management expense	4,000.00	
Interest expense	810.00	
Investment tax credit (10%)*	3,000.00	
Total equivalent deductions		$10,252.90
Second year:		
Management expense		
Interest expense		
Cash paid out 197__		$ 4,810.00
Tax effect:		
Depreciation†	$3,673.50	
Management expense	4,000.00	
Interest expense	810.00	
Total deductions		$ 8,483.50
Third year:‡		
Management expense		$ 7,000.00
Interest expense		810.00
		$ 7,810.00
Income (estimated sales $6,000 ÷ 50%)		3,000.00
Cash paid out 197__		$ 4,810.00
Tax effect:		
Depreciation	$2,623.90	
Management expense	4,000.00	
Interest expense	810.00	
Total deductions		$ 7,633.90

* Investment tax credit assumes a 50 percent tax bracket and a tax credit being the equivalent to $3,000 of standard deductions.
† Balance of depreciation is $6,559.70.
‡ No direct cash investment after third year.

message we want to get to the American people. If you're going to eat red meat, then why not eat something that's good for you.''

42 To identify his project, Schweiger initially used the name Beefalo Inns, then later changed to Beefalo Barns. He spoke of the need to approach the naming of the restaurant from a scientific view, but suggested that tentatively the barn concept captured the architectural style with its gabled roof atop the log structure. He was further thinking about freeway locations for the first Beefalo Barns in order to quickly expose people to the idea. ''If we use freeway locations, people are adventuresome, so they're going to try it. The type of building housing our restaurant is a totally new concept in

exhibit 1-D
Economic projection seven-year program*

	Ordinary income	*Capital gains*	*Total*
Total sales	$90,000	$136,800	$226,800
Expenses:			
Cost of Herd	15,000		15,000
Management and marketing			
Original fees	14,000		14,000
50 percent of sales	45,000	68,400	113,400
Interest	5,670		5,670
Total	79,670	68,400	148,070
Net profit before taxes	10,330	68,400	78,730
Net tax liability below†			17,345
Net aftertax profit			$ 61,385
Taxes:			
Net profit before tax	10,330	68,400	78,730
60 percent capital gain exclusion		41,040	41,040
Total taxable	$10,330	$ 27,360	$ 37,690
Tax on above at 50 percent			18,845
Investment tax credit			1,500
Net tax liability (above)			$ 17,345

* Assumptions:

1. An expected 100 percent live calf crop in the first year and an 80 percent calf crop thereafter. That 50 percent are male and 50 percent are female and all females are breed and calve annually.
2. The original herd increases to 126 head and the average price is $1,800 per head and herd liquidation takes place at the end of seven years.
3. That 40 percent of sales is ordinary income and 60 percent is capital gains.

† For the purposes of this computation it has been assumed that the 50 percent management fee would be deducted against the proceeds to which they relate. Accordingly, a substantial portion ($68,400) has been deducted against capital gains income. Had this instead been reflected as an ordinary deduction, the net tax liability of $17,345 would have been a net refund of $3,175 or additional net aftertax profits of $20,620.

The analysis of economic benefits are based on assumptions concerning future events and present tax laws (which may be changed). Some assumptions may not occur which could have substantial effect. Therefore the actual results obtained may vary considerably from the projections.

fast-food buildings. We also have a meat product that probably 99 percent of the American public still have not tasted. But it is being more widely know and advertised everyday."

43 The principal feature of Beefalo Barns would be a variety of burgers. Schweiger would prefer to use all fresh meat, to achieve further product distinctiveness similar to Wendy's. He would use the Burger Chef concept of a condiment bar to allow customers to add what they like. Steaks might possibly be offered; if so the selections probably would be a 6-ounce ground beefalo steak and an 8-ounce rib eye. Prices would be competitive, but probably 10 percent over McDonald's or Burger Chef. "Basically what we want to shoot for is $1.70 average ticket covering patties, fries, drink, and apple turnover."

44 Schweiger estimated that at least two restaurants would be necessary to test the feasibility of continued expansion. Although the first facility probably would be wholly owned, he projected moving quickly to joint venturing or franchising. "I would see getting into the fast-food business as a vehicle for a national franchise. To me, who needs the hassle of operating simply one restaurant." Six facilities were seen as a feasible target for the first year, with additional facilities limited only by the number of animals available for slaughter. He thought that one way of assuring adequate meat supply would be to involve other breeders as limited partners, stockholders, or franchisees. Schweiger noted that there are approximately 50 beefalo breeders in Kentucky and Tennessee, so that might be a natural area in which to expand. Nationally, there are breeders in the 48 continental states. (Two pages of a 10-page proposal circulated to interested breeders and parties are reproduced as Exhibits 2-A and 2-B, which include the introduction and pro forma income statement.)

45 During 1978 Schweiger entered into negotiations with property holders of several potential sites. (See map in Exhibit 3.) One site was at the Pocahontas exit off I-70, about two miles from the KSM sales office and Korte farm. Preliminary studies indicated a year-round average traffic count under the interstate overpass at 11,000 cars per day in 1976 with a summer average of 13,900. The exit traffic (coming off the interstate) was 4,000 cars per day of

exhibit 2-A
Sample pages of Beefalo Barn proposal

Introduction

Beefalo Barns offers a new and exciting approach to the fast-food industry. The serving of beefalo exclusively in the atmosphere of early American log buildings combine to offer a unique dining experience for the consumer.

The format of the Beefalo Barns will combine the features of several fast-food type restaurants and will offer both eat-in and carry-out service.

The success of the so-called fast-food industry and the forecast for future growth is a phenomena in the business world. When one considers that in 1960, just 18 years ago, there were virutally no fast-food chains, it is difficult to realize the tremendous impact these outlets have had and the amount of the consumers' food dollar that is going into their cash registers.

Most people are familiar with the golden arches of McDonald's or the goatee of Colonel Sanders, but few realize the true magnitude of their operations. McDonald's alone uses the hamburger from 20,000 head of cattle per week, Kentucky Fried Chicken uses about 7 percent of our total poultry production, and these are but two of a long and growing list of chains, i.e., Wendy's, A&W, French's, Taco Bell, Zantigo, Burger Chef, Dairy Queen, Burger King, Pizza Hut, etc.

Combined annual sales of the fast-food industry today exceeds $20 million and represents about 35 percent of all food dollars.

We, at Beefalo Barns, strongly believe that there is room for one more, one that is built around a new meat called beefalo. We hope as you evaluate the balance of the material in this brochure that you will come to the same conclusion and will join with us in this new venture.

exhibit 2-B

BEEFALO BARN
Pro Forma Income and Expense ($000)

Gross sales	100%	$200,000		$300,000		$400,000
Food costs	32	64,000		96,000		128,000
Gross profit	68	136,000		204,000		272,000
Operating expenses:						
Labor	22.0%	44,000	21.0%	63,000	20.0%	80,000
Employee taxes, Benefits	3.0	6,000	3.0	9,000	3.0	12,000
Paper goods	4.0	8,000	4.0	12,000	4.0	16,000
Utilities	2.0	4,000	2.2	6,600	2.5	10,000
Laundry	.5	1,000	.6	1,800	.7	2,800
Advertising	1.5	3,000	1.8	5,400	2.0	8,000
Office supplies	.3	600	.4	1,200	.5	2,000
Telephone	.6	1,200	.6	1,800	.6	2,400
Legal and accounting	.5	1,000	.8	2,400	.7	2,800
Insurance	1.5	3,000	1.5	4,500	1.5	6,000
Maintenance and repairs	1.0	2,000	1.0	3,000	1.0	4,000
Miscellaneous	1.0	2,000	1.0	3,000	1.0	4,000
Total operating expenses	38.4	75,000	37.9	113,700	37.5	160,000
Fixed costs:						
Land and building		16,000		16,000		16,000
Equipment and fixtures		14,000		14,000		14,000
Total fixed costs	15.0	30,000	10.0	30,000	7.5	30,000
Total costs	85.4	169,000	79.9	239,700	77.0	318,000
Net income	14.6%	$ 31,000	20.1%	$ 60,300	23.0%	$ 82,000

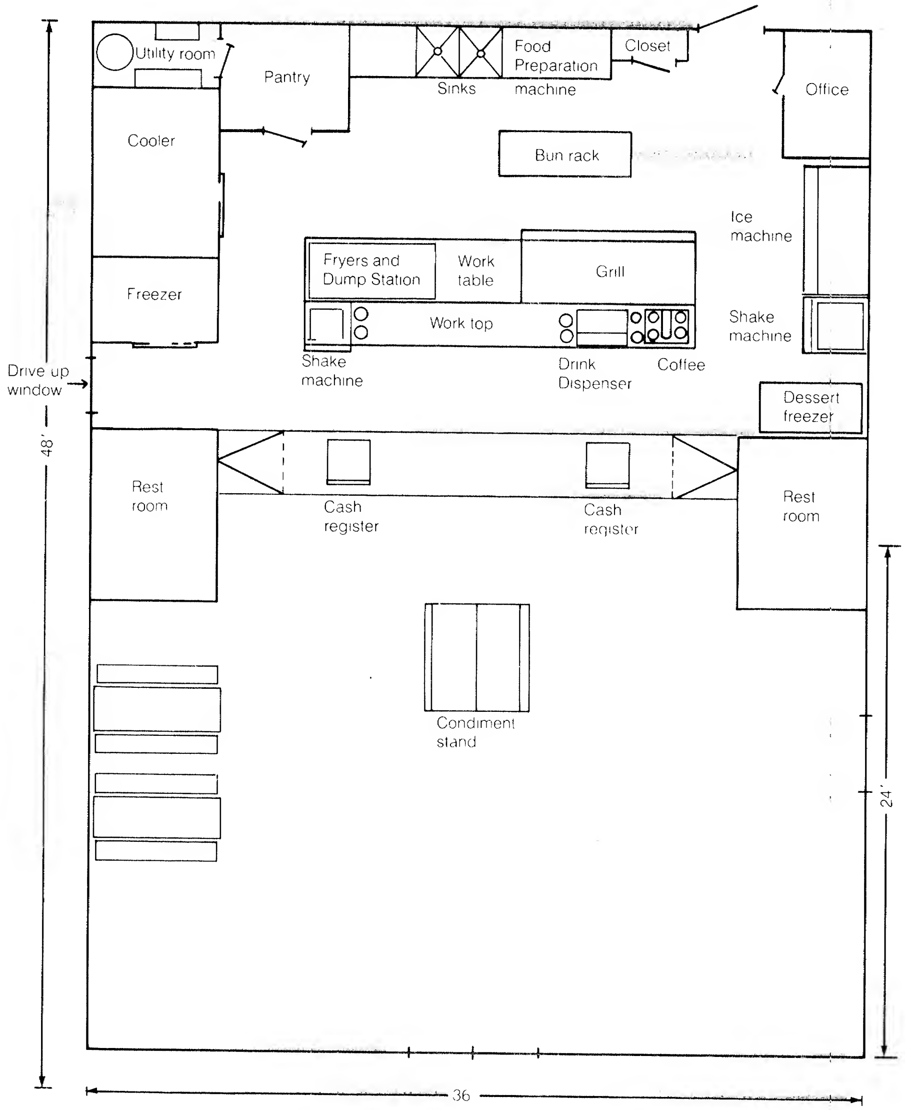
Note: Land and building costs can vary substantially from unit to unit. Equipment and fixtures are assuming five-year lease.

which 20 percent was considered to be local traffic. Year-round passenger count per vehicle was 1.7, while during the months of May through September it was 2.5. Based on these figures, Schweiger calculated that roughly 3,700 persons per day might be looking for food or other services such as gasoline. He commented: "If we can tap 15 percent of the potential traffic May through September, we can pay all of our bills, gross $150,000, and lock up the place for six months if need be (the nontourist season)."

46 Negotiations were entered into for a second site, also adjacent to I-70, but several miles to the west at the Illinois 143 exit. This property is owned by King Oil Company who operates a truck stop at the off-ramp location (the only commercial establishment at the exit). The oil company tentatively would be willing to construct the building with site improvements (exclusive of interior equipment) and lease the facility to Beefalo Barns for a 10 percent return to King (lease payments estimated $6–7,000 annually). Schweiger, thought such terms to be advantageous:

> I don't see how we can go wrong in putting in the equipment and opening this location because it certainly reduces the sales volume necessary to meet the lease obligation. The other advantage obviously is that it eliminates a lot of front-end cash requirements on our part. Where we were nominally look-

exhibit 3
Beefalo Barn restaurant layout (seating = 66)



ing at probably $60–100,000 cash up front, we are probably looking at $25–40,000 maximum with this type of arrangement. As a pilot program, obviously the lower you can keep your cash requirements the better off you are going to be.

47 The King Oil site probably would be operated year-round because of the steady flow of trucks and cars that normally stop for refueling. Among other

sites where investor contact had been made was one in conjunction with a sports complex at Rend Lake (seasonal resort area) and a downtown location in Mt. Vernon (year-round). Schweiger indicated that a group of Illinois and St. Louis investors expressed an interest in owning the Beefalo Barn at the Mt. Vernon site:

> Tentatively we would set up ownership on a limited partnership basis, and we (Beefalo Barns, Inc.) would be the general partners. We would probably establish 50 units at $2,100 per unit, with a two-unit minimum to comply with Illinois security statutes of limiting the partnership to 25 or fewer investors. Of the $105,000 we would raise, $100,000 would be applied to the partnership capital account and $5,000 would cover organizational expenses. We would then as a partnership acquire the land, build the facility, lease the equipment, and provide the operating capital. With such an arrangement, we would probably go in as general partners at 30–40 percent participation, with no capital contributions. The limited parnters would pick up 60–70 percent with their capital contribution. As general partners we would not participate in any partnership profits until all limited partners had received back their capital contributions. Once they have 100 percent return, then we participate on a proportional basis.

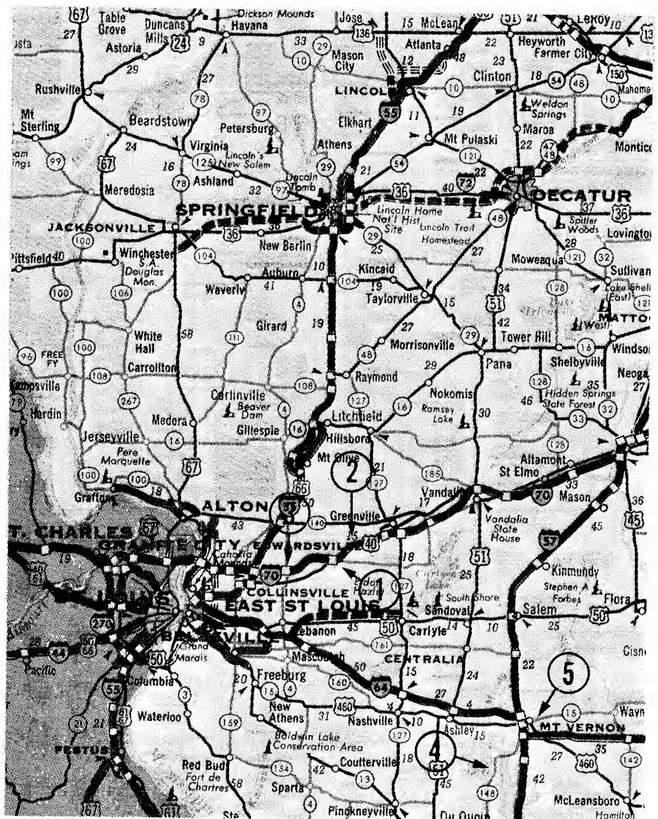
48 Management believes they would be unable to require large franchise fees, should this be the direction of expansion. In the absence of an established record, they are considering not charging a franchise fee, per se, but charging a predetermined fee based on franchise performance. A tentative front-end fee of $5,000 was discussed to cover Beefalo Barn's expenses for assistance in site location, building design, equipment lineup, etc. The franchisee would have total obligation for purchasing equipment, land, and building. Beefalo Barns would then charge a royalty fee based on dollar sales of beefalo purchased through the parent firm.

49 The Beefalo Barn restaurant would use a 36-by 48-feet Beaver log building, with seating capacity for 66 people (see Exhibit 4). Decor would be in a western motif with wooden tables, wagon wheel light fixtures, cattle brand displays, etc. Service equipment would use standard models (not customized), with a gas-fired fry grill used for cooking. Schweiger anticipated relying heavily on experienced managers (or formally trained food service managers from one of the special schools in Dallas, Las Vegas, or Purdue) for operation of the restaurants. Some standards would be established regarding personnel, sanitation, and food storage/preparation. But largely, individual restaurant managers would have responsibility and authority to manage their operation in response to local conditions. For example, deciding whether to open for breakfast and the specification of breakfast menu items would be the manager's prerogative.

50 Schweiger emphasized that quality control is the primary factor on which success is dependent:

> To me, the most critical factor in the whole thing is the movement of meat from the feedlot, through the slaughterhouse, to the retail outlet. To

exhibit 4
Proposed Beefalo Barn locations



Key:
1—KSM/BBC.
2—Pocahontas.
3—King Oil.
4—Rend Lake.
5—Mt. Vernon.

start out, we're only going to have one to three stores and we're going to be starting from scratch. So we've got two things to worry about initially—to control the quality of that meat and keep spoilage down, and yet to maintain adequate supplies at the restaurant, because the last thing you need to do is to run out.

The future

51 By early 1979, the future direction for KSM and Beefalo Breeding Company remained uncertain. During mid-1978, the Beefalo Barns idea was very central to the thinking of Schweiger. It presented not only an outlet for beefalo in which maximum value could be added to the product, but also an oppor-

tunity to branch out into another business. Six months later, however, no commitments had been made to start the first restaurant. In the interim, Schweiger had been closely involved with a group of investors in southern California, who were considering not only the tax-sheltering possibilities of beefalo, but who also expressed interest in the concept of marketing beefalo through restaurants (tentatively located either in California or Colorado). This group potentially could assemble a multimillion dollar capital investment fund within 72 hours. Their major reservation to date about starting a restaurant chain was concern over the availability of a guaranteed supply of beefalo. They estimated at least 1,000 cows producing calves for meat would be necessary to sustain the scale of operation this group felt necessary to make attractive a major investment.

52 In the first year in which beefalo were available for meat production, about $50,000 was generated through red meat sales. The most recent sale involved 4,200 pounds of ground beefalo to an Oklahoma public school system for institutional feeding (cafeterias). By February 1979, Beefalo Breeding Company was caring for approximately 500 head of beefalo, about two thirds of which involved herd management contracts for outside investors. Seventy-five head had recently arrived at the Missouri ranch from a prominent California beefalo producer. It was expected that a management contract for another 250-head herd would be finalized within 60 days. In anticipation of herd expansion, on February 15 Schweiger was meeting with representatives of property east of Jefferson City, Missouri to work out terms for a 15-year lease of 600–880 acres of pastureland, capable of supporting 400 head.

53 Schweiger continued to feel himself stretched thin in terms of being able to devote ample time to his various programs. Much of his time was involved in negotiating and attempting to persuade various individuals and groups in one or more facets of his existing or proposed businesses. He talked at one time of taking an on assistant, but finding a relatively young person who could function as a jack-of-all-trades with high tolerance for uncertainty was difficult. Hiring such a person at this time also was complicated by limited cash flow, since herd buildup required keeping cows out of the marketing stream for breeding purposes.

54 In discussing his dilemma with a class of M.B.A. students, Schweiger remarked:

> I'm not reasonably sure at this time which of our business activities ought to be emphasized. Which way do I go? Should I spend most of my time raising capital for buying beefalo herds and in finding high-paying outlets for carcass beefalo? If so, what would be my best approach to marketing? What do I do with the Beefalo Barns idea, or with Beaver Homes? What are the trade-offs and payoffs? I'm open to your suggestions?

case 19

Aero Manufacturing Company, Inc.

1 On March 15, 1975, Gerald Giles, president of the Aero Manufacturing Company, Incorporated, called a meeting of his staff to discuss the position of the firm. Giles had just received from Jochim, the financial manager, the annual report for the year ending February 28, 1975. While gross sales increased to $4,369,568, net income after taxes had declined to $313,788. It was Giles's desire to locate the problem areas, review appropriate solutions proposed by the staff, and implement the necessary changes to return the Aero Manufacturing Company to the rapid growth of sales and earnings which was its pattern in the past.

History of Aero Manufacturing

2 The Aero Manufacturing Company, a closely held corporation, produces a highly diversified line of products for use in the agricultural industry. The products, which include grain-drying-and-handling equipment, rolled steel tubing, and, until very recently, golf carts and minibikes, have traditionally been marketed throughout the Midwest. The firm markets its grain equipment to dealers via distributors in Iowa, Nebraska, Missouri, Illinois, Minnesota, North Dakota, South Dakota, Kansas, and Colorado.

3 Initially, Giles had established an electric motor service in Wayne, Iowa, in 1955. In 1958, he expanded that service to a second outlet in the Pisgah Industrial Park, Pisgah, Iowa. He named the new firm Midland Electric Motor Service. This company specialized in electric-motor rewinding and repair. His background in electrical maintenance and servicing of grain-drying equipment led to his desire to design drying equipment to function with less specialized supervision. In due course, Aero Manufacturing was founded by Giles in May of 1964. This company was an outgrowth of companies he had previously established. The initial capital of this firm was $9,900. Giles developed his first crop dryer in 1966, and adopted the trade name Grain-Air. The trade name was registered with the U.S. Patent Office.

4 Growth of the company had been rapid in terms of sales, product line, and expanded facilities since 1964. As development of the crop dryers progressed and they became widely accepted in the field, the company rapidly expanded the product line to include other component accessories related to grain drying and handling. Additional product offerings included perforated plank-type drying floors, steel substructures, grain spreaders, bin ladders,

This case was prepared under the direction of Bruce A Kirchoff of the University of Nebraska-Omaha.

exhibit 1

AERO MANUFACTURING COMPANY, INC.
Balance Sheet
For Years Ending February 28, 1965–1975

	1975	*1974*	*1973*
Assets			
Current assets:			
Cash	$ 24,435	$ 40,827	$ 23,050
Certificates of deposit	0	125,573	100,391
Account receivable—trade	253,648	419,992	258,108
Account receivable—other	1,215	63,875	13,975
Inventory at cost	1,905,000	990,946	406,581
Other assets:			
Investments (at cost)	7,500	7,500	7,500
Loans to employees	2,115	0	0
Other assets—prepaid taxes	395,449	0	0
Fixed assets:			
Buildings and land	363,364	377,687	377,687
Furniture and equipment	589,769	454,546	278,017
Less accumulated depreciation	(284,306)	(199,390)	(127,608)
Total assets	$3,258,189	$2,281,486	$1,337,701
Liabilities and Stock Holders' Equity			
Current liabilities:			
Accounts payable	$ 564,172	$ 510,457	$ 223,645
Customer deposits	0	45,167	0
Accrued efpenses	108,045	139,704	22,154
Accrued income—taxes payable	283,536	210,284	142,400
Current portion—mortgage payable	32,000	32,698	30,681
Current portion—contracts payable	14,600	7,088	4,958
Cash in bank—overdraft	0	0	0
Notes payable—current portion	600,000	0	0
Notes payable—officers	27,261	0	0
Long-term liabilities:			
Notes and contracts payable	49,719	41,098	7,820
Mortgage payable	241,363	271,285	304,380
Total liabilities	1,920,696	1,257,781	736,038
Stockholders' equity:			
Common stock	106,100	106,100	106,100
Paid-in surplus	18,800	18,800	18,800
Retained earnings	1,212,593	898,805	476,763
Total stockholders' equity	1,337,493	1,023,705	601,663
Total liabilities and stockholders' equity	$3,258,189	$2,281,486	$1,337,701

unloading sumps and augers, sweep augers, and a full line of aeration fans and aeration systems. Aero decided not to produce grain bins, since management thought Aero could not be competitive.

5 The first building for Aero Manufacturing measured 50 feet by 100 feet, and was erected in 1965. Gross sales reached $35,372, and profit after taxes reached $5,460 in 1965. Building space was doubled in size the next year, and in 1967, another 4,000 square feet was added to the building. That same year, Aero Manufacturing acquired a plant at Ames to house the perforated-floor machine and the steel-tube mill. Sales had risen by this time to $169,086.

1972	*1971*	*1970*	*1969*	*1968*	*1967*	*1966*	*1965*
$ 48,867	$ 0	$ 15,293	$ 14,800	$ 34,110	$ 8,742	$10,082	$ 5,227
85,750	0	0	0	0	0	0	0
106,241	58,091	63,722	43,031	30,741	9,565	2,342	3,336
1,215	1,786	5,280	19,480	48,304	0	0	0
221,032	162,683	113,419	106,321	0	49,762	2,000	775
7,500	9,417	38,417	2,500	8,169	0	0	0
7,472	2,298	2,207	2,755	970	152	297	0
985	0	0	0	0	259	1,549	485
376,723	180,613	59,234	50,262	40,001	28,665	25,983	13,853
148,925	0	0	0	0	0	0	0
(72,480)	(39,387)	(23,778)	(17,562)	(12,417)	(8,510)	(4,730)	(1,860)
$932,230	$375,501	$273,794	$221,587	$149,878	$88,635	$37,523	$21,816
$112,471	$ 44,253	$ 51,666	$ 52,783	$ 24,880	$11,126	$ 8,834	$ 5,781
0	0	0	0	0	0	0	0
4,601	1,790	10,677	12,182	16,806	1,192	0	0
76,659	18,785	16,062	16,642	12,424	7,604	1,423	635
55,486	0	0	0	0	0	0	0
5,566	0	0	2,745	2,618	0	0	0
0	6,711	0	0	0	0	0	0
0	41,500	15,000	0	0	3,490	0	0
0	0	195	0	0	0	0	39
0	0	0	0	0	0	0	0
307,888	0	0	0	0	0	0	0
562,671	113,039	93,600	84,352	56,728	23,412	10,257	6,455
101,000	100,000	55,400	43,700	28,900	28,900	12,900	9,900
0	0	0	0	0	0	0	0
268,559	162,462	124,794	93,535	64,250	36,323	14,366	5,461
369,559	262,462	180,194	137,235	93,150	65,223	27,266	15,361
$932,230	$375,501	$273,794	$221,587	$149,878	$88,635	$37,523	$21,816

6 It was Giles's aim to develop one or more new products each year. In line with this goal, a tube mill was built in 1969 and to roll six-inch pipe from 14- to 16-gauge galvanized steel, and to produce black steel pipe for general farm use. Aero's spectacular growth continued unabated through 1969, with sales topping $397,000 and net income after taxes climbing to $29,363.

7 The rate of sales growth for Aero Manufacturing slowed during 1971, with sales increasing by only $29,905 over 1970. Short-term debt tripled from the previous year to $41,500 (see balance sheet in Exhibit 1). In addition, increased capital of $44,600 was obtained trhough the issuance of common stock.

8 In April 1972, anticipating continued sales increases and in need of additional space for production and storage, Aero purchased a 150,000-square-foot factory building in Pisgah, Iowa. The company obtained a Small Business Administration loan of $365,000 to acquire the new facility, which had formerly housed the Monastersky Manufacturing Company of Pisgah, Iowa.

9 Through the period ending February 28, 1974, sales increased to $3,876,101, while net income after taxes increased to $424,909. No further expansion of Aero Manufacturing facilities occurred until the company announced plans in late 1974 to locate a branch in Akron, Iowa.

Aero Manufacturing's current position

10 The firm experienced difficulties in several areas during the year ending February 28, 1975. A majority of these could be directly traced to the economic recession the nation was experiencing during the latter part of 1974 and into early 1975. The overall result was that farmers were reluctant to make new purchases, and the result was a much poorer year than was anticipated by Giles for Aero Manufacturing.

Marketing

11 Gross sales increased during 1974 to $4,369,568. This was an increase of 12 percent over the previous year, but it was significantly lower than the $6 million which had been projected. Net income after taxes decreased to $313,788. A schedule of income statements is presented in Exhibit 2. Gross sales by product line is presented in Exhibit 3.

12 Giles hoped to expand his sales territories, although he had no specific goal in regard to market share, nor had he adequately defined his market. In this regard, Giles hired a marketing manager in February 1975 to revamp and implement current and future marketing strategy. While no change was contemplated in the company's present pricing policy, Giles had been seriously considering increasing the number of dealers.

13 Aero's present competitors in the grain-drying field are Chicago Eastern and Farm Fans. The firm's main competitor in the tubing area is Valmont. Other competitors include Midwest Equipment, Square D, and Wigman. Major manufacturers have not been in direct competition, since Aero sold its product for 15 to 25 percent less.

14 Even though the company wished to introduce one or two new products every year, the products designated for 1975 were still in the research stages as of February 28, 1975.

15 Aero is presently advertising in *Iowa Farmer, Farm Journal,* and other regional farm magazines.

exhibit 2

AERO MANUFACTURING COMPANY, INC.
Income Statement
For Years Ending February 28, 1965–1975

	1975	*1974*	*1973*	*1972*	*1971*	*1970*	*1969*	*1968*	*1967*	*1966*	*1965*
Gross sales:	$4,369,568	$3,876,101	$1,998,279	$1,116,716	$496,845	$466,940	$397,612	$267,452	$169,086	$67,201	$35,372
Sales returns and allowances	(158,835)	(116,649)	(59,556)	(54,381)	(26,225)	(29,226)	(12,509)	(20,048)	0	(1,553)	0
Discounts	(35,797)	(32,604)	(16,422)	0	0	0	0	0	0	0	0
Net sales	4,174,936	3,726,848	1,922,301	1,062,335	470,620	437,714	385,103	247,404	169,086	65,648	35,372
Cost of goods sold:											
Beginning inventory	990,946	406,581	221,032	162,683	113,419	106,321	48,304	49,762	2,000	775	0
Raw material purchased	2,967,638	2,449,820	1,088,830	560,957	238,980	214,005	272,265	122,335	128,765	30,924	12,781
Production labor	412,270	263,440	148,158	87,399	83,587	74,651	51,097	38,283	24,419	12,354	11,667
Supplies	51,826	7,698	10,606	20,567	21,865	18,838	9,173	4,618	5,416	1,947	1,337
Freight	34,600	32,469	14,874	15,564	8,956	4,671	5,350	0	0	0	0
Total goods available:											
Ending inventory	4,457,280	3,160,008	1,483,500	847,170	466,807	418,486	386,189	214,998	160,600	46,000	25,785
Cost of goods sold	(1,905,000)	(990,946)	(406,581)	(221,032)	(162,683)	(113,419)	(106,321)	48,304	(49,762)	(2,000)	(775)
Gross profit on sales	2,552,280	2,169,062	1,076,919	626,138	304,124	305,067	279,868	166,694	110,838	44,000	25,010
Operating expense	1,622,656	1,557,786	845,382	436,197	166,496	132,647	105,235	80,710	58,248	21,648	10,362
Net profit from operations	1,066,217	810,310	510,725	287,368	104,212	80,525	58,400	40,358	28,687	11,319	4,267
	556,439	747,476	334,657	148,829	62,284	52,122	46,835	40,352	29,561	10,329	6,095
Other income:											
Rental income	3,550	36,219	49,861	42,514	0	0	0	0	0	0	0
Interest and other	37,335	38,347	5,686	1,492	0	0	20	0	0	0	0
Total other income	40,885	74,566	55,547	44,006	0	0	20	0	0	0	0
Net profit before state and federal taxes	597,324	822,042	390,204	192,835	62,284	52,122	46,855	40,352	29,561	10,329	6,095
State and federal income taxes	283,536	397,133	10,630	86,739	24,617	20,862	17,492	12,424	7,604	1,423	635
Net profit after taxes	$ 313,788	$ 424,909	$ 209,574	$ 106,096	$ 37,667	$ 31,260	29,363	$ 27,928	$ 21,957	$ 8,906	$ 5,460
Net income per share	$ 295.74	$ 400.47	$ 197.52	$ 105.04	$ 37.67	$ 56.42	$ 67.19	$ 96.63	$ 75.97	$ 69.03	$ 55.15

exhibit 3

Gross sales by products by month for fiscal 1975

	March	April	May	June	July	August	September
1974:							
Aeration fans	$ 36,920	$ 72,144	$ 67,582	$121,162	$ 83,023	$ 44,247	$ 72,483
Aeration accessories	2,912	9,390	19,802	18,183	15,154	22,974	13,954
Vent fans	2,684	11,323	9,816	11,422	13,357	4,536	5,042
Vent fan accessories	788	3,218	1,554	8,088	5,585	3,088	4,368
Drying fans	58,788	39,303	15,605	54,380	30,909	51,990	56,887
Drying burners	6,535	7,448	5,517	20,082	12,834	9,394	17,209
Drying accessories	2,822	8,990	5,710	8,115	10,514	9,120	6,578
Vaporizers	0	0	0	0	0	0	394
Centrifugal fans	28,264	20,358	27,249	27,087	31,855	53,770	45,809
Centrifugal fan accessories	4,200	3,891	3,083	5,648	6,447	29,223	10,509
Electric humidity controllers	11,066	31,507	16,618	25,381	22,574	25,020	33,260
Johnson products	993	0	0	0	297	330	2,114
Zelbarth products	0	0	0	0	0	858	238
Bin liners	255	560	0	68	2,056	609	1,325
A & V aerators	0	13	0	0	165	1,198	87
Irrigation pump crib	0	0	0	2,216	752	523	609
Golf carts and mini bikes	674	46	0	17	30	257	667
Electric motors	7,307	11,621	23,194	4,515	13,209	3,724	3,747
Miscellaneous	1,805	3,159	2,899	676	3,954	9,743	2,315
Augers	4,477	8,290	15,431	8,297	27,978	34,482	22,453
Hofard augers	0	0	7,826	18,225	8,307	4,479	10,541
Spreaders 20-24-30	648	349	6,337	616	842	941	1,004
Fibers	16,364	21,594	24,252	15,805	48,291	37,891	32,991
Channels	6,436	4,910	7,458	2,843	12,884	13,968	3,809
Supports	2,587	19,166	10,206	3,982	16,706	19,408	8,580
Floor parts	0	591	4,312	453	3,690	242	837
Aeration flush	891	2,588	7,574	4,284	2,680	1,736	1,028
Moisture testers	2,331	1,797	3,225	0	1,787	2,322	734
Mufflers	55	0	0	30	0	0	127
Motor repair stand	639	0	633	0	0	1,462	0
Probe meter	0	110	0	0	62	28	80
Hog sorting gate	0	0	0	0	0	0	93
Pipe 6″ and 8″	81,362	97,918	149,834	109,412	108,528	229,287	70,369
Power outlets	0	0	0	0	0	0	0
Total	$281,803	$380,284	$435,717	$470,987	$484,470	$616,850	$430,241

exhibit 3 ***(concluded)***

	October	November	December	January	February	Total
1975:						
Aeration fans	$ 32,438	$ 43,156	$ 14,203	$19,450	$ 1,393	$ 608,201
Aeration accessories	22,942	14,557	4,358	2,737	5,798	152,761
Vent fans	7,376	20,101	2,372	3,061	965	92,055
Vent for accessories	3,751	3,753	1,154	1,168	722	37,237
Drying Fans	36,839	44,466	14,222	(2,863)	355	400,881
Drying burners	13,471	10,227	9,370	(20)	(4)	112,063
Drying accessories	10,627	19,663	2,246	2,276	418	87,079
Vaporizers	2,600	3,515	66	(66)	(241)	6,268
Centrifugal fans	52,485	44,713	7,127	2,013	9,193	349,923
Centrifugal fan accessories	21,407	9,102	1,664	1,997	3,234	100,405
Electric humidity controllers	16,450	22,234	2,412	(353)	81	206,250
Johnson products	524	524	567	1,700	0	7,049
Zelbarth products	879	238	0	0	0	2,213
Bin liners	4,138	757	0	0	0	9,768
A & V aerators	521	358	44	87	165	2,638
Irrigation pump crib	1,492	413	0	0	0	6,005
Golf carts and mini bikes	226	175	0	0	48	2,140
Electric motors	7,404	21,555	2,174	1,535	374	100,359
Miscellaneous	2,130	4,512	372	3,075	36,531	71,171
Augers	19,970	15,401	1,658	2,717	1,591	162,745
Hofard augers	15,823	7,595	674	(217)	0	73,253
Spreaders 20-24-30	4,902	1,305	0	14	52	17,010
Fibers	12,991	8,486	1,608	1,746	1,575	223,594
Channels	5,909	3,162	960	367	420	63,126
Supports	6,858	4,733	1,247	294	342	94,109
Floor parts	5,720	1,645	159	61	635	18,345
Aeration flush	3,888	299	311	505	0	25,784
Moisture testers	2,356	2,238	750	0	140	17,680
Mufflers	37	0	24	0	42	315
Motor repair stand	0	657	0	0	62	3,453
Probe meter	279	110	736	783	0	2,188
Hog sorting gate	0	0	0	0	0	93
Pipe 6″ and 8″	77,269	60,246	52,162	18,584	35,368	1,090,339
Power outlets	0	0	0	0	1,503	1,503
Total	$393,702	$369,896	$122,640	$60,651	$100,762	$4,148,003

Finance

16 Inventories climbed throughout 1974 to reach a level of $1,905,000 as of February 28, 1975, the company's fiscal year-end. This amounted to an increase of 92 percent over the previous year. The inventory accumulation resulted in approximately three times too much in raw materials, and two and one-half times too much in finished goods. The majority of the inventory was being stored at the Pisgah plant. Approximately 75,000 additional square feet was added within the building by constructing a second floor which was used to store the excessive inventory. Giles stated that the main reason for this inventory buildup, besides the recession, was that the firm experienced a great difficulty in obtaining raw steel products in earlier years of peak demand, and Giles did not want to jeopardize relations with suppliers by cancelling orders. He also stated that a similar buildup on a much smaller scale had occurred in 1971.

17 The increase of raw materials and finished-goods inventory, coupled with the reduced sales, was making it difficult for the firm to reduce its short-term debt. As a result of this, and a new law requiring prepayment of corporate income taxes, Aero Manufacturing was unable to liquidate $600,000 worth of short-term debt by the end of the 1974 fiscal year. This was the first time in its history, according to Giles, that the corporation was unable to eliminate its short-term debt by the end of the fiscal year. Although the line of credit extended by the bank was $1,250,000, the short-term debt and the cash-flow situation were causing deep concern among the firm's management. A schedule of operating expenses is presented in Exhibit 4.

18 Aero offered credit terms of 2/10, net 30 to its dealers. The firm also had an early discount policy of allowing 55 to 10 percent, if the dealer would pay 25 percent down at the time of purchase.

19 Aero Manufacturing currently employs between 50 and 60 people. Even though the economic climate was deteriorating in 1974, Giles continued to produce finished goods because he felt it was Aero's social responsibility to keep its people employed. It was also difficult to obtain, retain, and house technically skilled people in a small town. Pisgah's population is 15,000. Nevertheless, approximately 30 percent of the work force had been laid off in late 1974 as the company continued to experience a sales slowdown. Total wages by department is presented as Exhibit 5. The organizational chart as of February 28, 1975, is presented as Exhibit 6.

Production/facilities

20 The Akron facility was leased in January 1975. It consisted of 10,000 square feet, 30 percent being office space. As of February 28, 1975, two people were employed at the site, and production consisted of one gravity grain box per day. Aero has also had an aluminum foundry at St. Thomas, Iowa.

21 Production is currently at 50 percent of capacity at the Pisgah site. The plant is full of inventory that has accumulated during the past year, and its

exhibit 4

Schedule of operating expenses for fiscal years indicated, year ending February 28

	1975	*1974*	*1973*	*1972*	*1971*	*1970*	*1969*	*1968*	*1967*	*1966*	*1965*
Commissions and selling expenses	$ 198,169	$158,808	$ 80,018	$ 60,813	$ 11,630	$13,613	$ 8,526	$ 2,637	$10,564	$ 2,181	$ 657
Depreciation and amortization	84,916	71,782	60,269	34,718	15,609	6,216	5,195	3,957	3,830	2,919	1,910
Bad debt expense	138,000	78,775	46,075	12,305	2,380	1,939	0	0	0	0	0
Administrative salaries	107,063	85,696	42,500	56,691	20,000	20,000	18,000	18,000	6,000	0	0
Employee benefits	41,933	42,089	31,728	4,620	483	2,096	808	339	267	0	0
Interest	48,927	29,788	31,660	27,968	2,986	2,141	1,467	514	616	719	417
Office salaries and wages	74,388	58,177	31,294	0	0	0	0	0	0	0	0
Truck and auto expense	63,479	31,473	26,139	2,026	6,035	2,201	1,945	606	0	69	0
Utilities	28,565	22,358	23,585	21,395	2,709	2,410	2,111	1,658	1,058	287	357
Insurance	34,503	28,045	17,510	21,167	6,605	3,155	1,212	2,025	1,008	355	116
Truck drivers' wages	30,521	26,516	17,057	0	0	0	0	0	0	0	0
Telephone	17,070	20,096	15,166	5,833	3,432	2,143	598	0	0	0	0
Real estate taxes	8,028	9,451	10,518	0	0	0	0	0	0	0	0
Advertising	17,433	13,856	8,486	8,142	7,974	3,414	4,182	1,412	1,019	471	9
Personal property taxes	12,504	6,698	8,450	3,560	3,330	3,737	2,193	1,519	466	189	0
Repairs and maintenance	15,460	14,626	7,901	0	0	0	0	1,125	455	45	107
Legal and accounting	17,323	9,472	7,105	8,106	2,370	1,779	1,803	1,199	425	275	0
Office supplies	18,741	11,386	6,879	4,883	2,116	2,692	1,225	677	479	330	263
Contributions	4,147	9,077	6,643	1,225	556	100	412	232	0	0	0
Travel	4,401	3,975	5,428	0	1,607	0	0	0	138	0	0
Miscellaneous expense	508	1,910	5,011	1,598	965	330	1,180	156	158	476	57
Licenses and permits	6,709	7,204	4,871	0	0	0	0	0	0	0	0
Machine shop wages	10,949	13,734	4,840	0	0	0	0	0	0	0	0
Shop supplies	10,003	7,036	4,748	5,541	2,439	1,812	605	0	0	1,803	274
Rent	4,740	1,527	3,027	1,719	8,885	8,424	4,800	2,400	1,800	1,200	100
Sales tax	1,032	1,562	2,286	4,058	1,101	1,323	0	0	0	0	0
Directors' fees	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,300	0	0	0
Dues and subscriptions	661	534	531	0	0	0	414	173	0	0	0
Tool and die wages	42,021	30,111	0	0	0	0	0	0	0	0	0
Freight out	15,256	11,080	0	0	0	0	0	0	0	0	0
Entertainment	2,562	1,217	0	0	0	0	0	0	0	0	0
Collection forms	1,928	1,251	0	0	0	0	0	0	0	0	0
Leased equipment	0	0	0	0	0	0	724	429	404	0	0
Research and development	3,277	0	0	0	0	0	0	0	0	0	0
Total	$1,066,217	$810,310	$510,725	$287,368	$104,212	$80,525	$58,400	$40,358	$28,687	$11,319	$4,267

exhibit 5
Total pay by department for fiscal year 1975

	Shipping	*Tool and Die*	*Truck Drivers*	*Machine Shop*	*Salesmen*	*Production*
March	$ 2,886.11	$ 1,802.22	$ 2,810.77	$ 1,059.11	$ 5,100.00	$ 26,906.82
April	2,623.02	1,878.97	2,868.01	959.65	3,040.00	21,744.55
May	2,979.62	2,103.10	2,363.14	953.62	11,302.07	22,633.16
June	3,794.56	2,085.85	2,626.31	874.64	4,240.00	29,428.00
July	4,403.17	3,116.60	2,331.83	1,091.06	14,090.00	39,450.79
August	3,642.67	2,928.02	2,171.67	885.86	4,215.00	28,147.93
September	4,194.98	3,049.55	2,783.76	852.12	3,040.00	24,761.90
October	6,026.78	4,314.05	3,274.65	528.66	15,300.00	30,931.49
November	3,992.72	4,334.76	2,260.55	864.47	13,040.00	19,812.43
December	2,737.98	6,201.59	2,306.72	923.65	33,240.20	21,516.53
January	2,565.94	5,168.69	2,280.39	946.17	14,106.00	21,301.80
February	3,079.32	5,030.94	2,442.86	1,019.35	19,701.00	22,025.92
Total	$42,925.87	$42,014.34	$30,520.66	$10,948.36	$140,414.27	$308,661.32

storage capacity is quite strained. Giles estimates that 40 percent of the Pisgah plant floor area is used for production; the remainder is for storage. A sales turnaround is expected, but as of March 1975, it had not yet materialized.

The future at Aero Manufacturing

22 Looking toward the immediate future, Giles plans to have his company back to full production within three months. He bases this plan on the assumption that the economy will be back to normal by that time. Giles has read that the consensus among the nation's leading economists is that the economy will bottom out by September of 1975, and the recovery will not really be felt until early 1976.

23 In fiscal 1976, the company is forecasting gross sales of $8 million, with a 20 percent profit before taxes. The sales forecast was revised down from an earlier projection of $10 million. If this new forecast is attained, Aero Manufacturing will have doubled its sales of $4 million in 1975. Also, the firm intends to reduce its short-term debt to zero by the end of fiscal 1976.

24 Giles plans to rely heavily upon his two new assistants, Bragg and Jochim. Bragg, the new marketing assistant, has had vast experience in marketing and sales with other similar agribusiness companies. Jochim is a CPA who used to conduct the annual audit for Aero Manufacturing. Both of these men will be responsible for developing plans and goals for their respective areas.

25 In regard to marketing strategy, Bragg has already decided that it is in the best interest of the firm to obtain more dealers. He is in the process of setting

St. Thomas	Maintenance	Service	Office	Electrical Division	Akron	Special Account	Total
$ 0	$ 0	$ 0	$ 4,340.66	$ 0	$ 0	$ 8,575.74	$ 53,481
0	0	0	4,861.52	0	0	4,000.00	41,965
1,129.60	0	0	5,982.32	0	0	4,000.00	53,446
300.25	0	0	4,987.24	0	0	4,067.50	52,404
560.16	0	0	6,582.08	0	0	6,179.56	77,805
1,475.34	0	0	5,352.75	0	0	5,834.56	54,653
2,027.91	0	0	5,387.31	0	0	6,514.56	52,612
2,668.16	646.52	0	6,908.00	0	0	8,143.20	78,741
1,945.42	944.86	664.40	5,527.29	148.50	0	6,514.56	60,048
1,923.62	672.80	1,720.24	10,538.40	267.51	0	7,041.05	89,090
2,257.45	729.60	1,492.66	6,961.65	358.20	0	10,943.20	69,111
2,317.65	1,038.07	1,610.87	6,957.87	497.42	273.01	10,249.34	76,243
$16.605.56	$4,031.85	$5,488.17	$74,387.09	$1,271.63	$273.01	$82,063.27	$759,605

up direct channels with more dealers via factory representatives. He is also venturing into new markets in Montana and Texas in an attempt to obtain new business. Bragg has stated that greater emphasis upon dealers will provide the firm with higher profit margins.

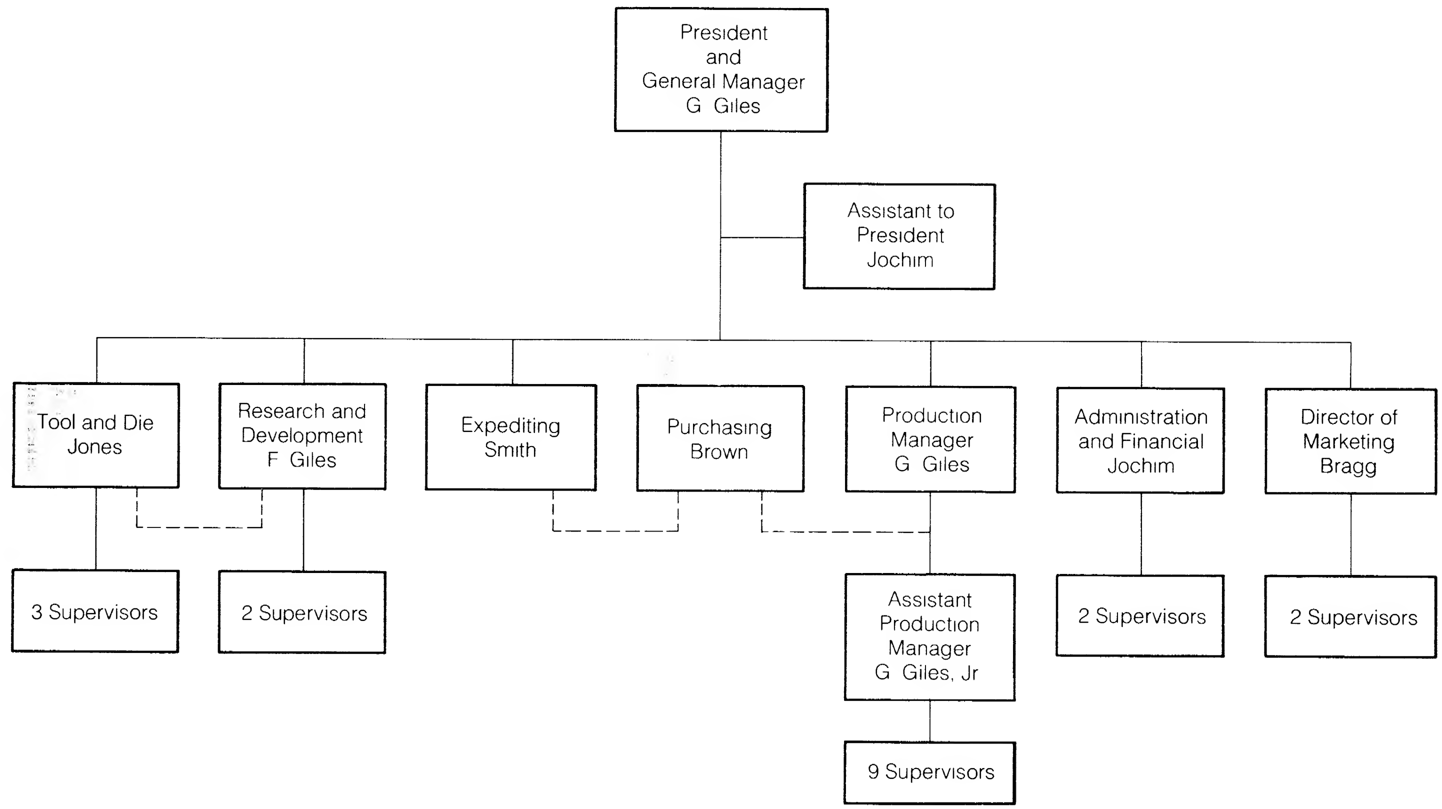
26 Concerning products, the firm still plans to come out with one or two new products every year. Giles plans to continue the firm's production of replacement auto mufflers because there is a strong demand for them. If the federal government relaxes its standards on emission controls (as appears likely) to the 1974 level, Giles thought that Aero would be able to sell its mufflers as original equipment, since they meet the 1974 standards. Management believes that they will be able to sell these mufflers throughout the continental United States, if these standards are lowered. The firm also plans to continue its production of new, technologically unique auto and tractor engine oil filters with the hope of obtaining bigger markets.

27 The firm has been directing its advertising toward the individual farmer, but recently, it has changed its emphasis from the farmer to the dealer.

28 In regard to acquisitions, Aero is and will continually be looking for opportunities. Firms that are in a financial bind and manufacture farm implements and machinery are prime prospects. Giles says, however, that he would rather buy the assets than the firm itself. He also believes that good bargains can be obtained in this manner, and that it opens up new markets for Aero's existing products.

29 As an overall policy, Aero plans to tighten its administrative internal control, and develop a managerial planning mechanism by instituting a management-by-objectives program. This, it feels, will provide better guidance to the various managers, and thus more efficiently utilize managerial talents.

exhibit 6
Organization Chart, February 8, 1975



section E
Implementation and review

case 20
Hoosier Home Federal Savings and Loan Association

1 In August 1978, Charles Sims, vice president in charge of personnel, went into Lew Winter's office complaining about the high turnover rate in the loan division. "I thought we had finally solved our personnel problem in the loan division when we still had Dan Davis and Ed Smith a year after they were hired. After firing Davis two weeks ago and finding out today that Ed plans to take another job, I am back where I started from 18 months ago." Winters looked up from his work, gave a sneer and declared, "As long as we have the old man's nephew running that division, the situation will never improve. How in the hell does Spears expect to run this association when the old man hands over the reins if he can't even keep one division operating smoothly?"

Background

2 The Hoosier Home Federal Savings and Loan Association (HHF) is a medium-sized savings and loan association doing business in three contiguous counties in northern Indiana. In recent years, Hoosier Home Federal has experienced a sizable growth in assets (see Exhibit 1). Part of this growth is attributable to an increase in the tri-county population from 260,000 in 1965 to just over 350,000 in 1975. The continuing industrialization of this area

This case was prepared by Professor W. Harvey Hegarty, University of Indiana.

exhibit 1

HOOSIER HOME FEDERAL SAVINGS AND LOAN ASSOCIATION
Statement of Financial Position, 1975, 1976, and 1977
($000)

Assets	*1975*	*1976*	*1977*
Cash and other	$ 1,656	$ 1,799	$ 1,217
Government securities	10,403	9,101	4,688
Federal Home Loan Bank stock	1,050	1,050	2,204
First mortgage real estate loans	127,438	136,866	155,354
Collateral loans	437	585	772
Property and fixtures	4,135	4,772	5,895
Total assets	$145,119	$154,173	$170,130
Liabilities			
Savings and investment accounts	$118,463	$124,688	$139,861
Escrows and loans in process	8,051	9,741	9,799
Customer collect and accounts payable	62	105	121
Advance payments by borrowers	149	162	158
Advances from FHLB	7,794	8,672	9,104
Reserve for loan losses	593	586	637
Capital and Surplus	10,007	10,219	10,450
Total liabilities	$145,119	$154,173	$170,130

was expected to result in a 5–10 percent annual increase in population over the next five years.

3 A second force behind HHF's growth was the adoption of more aggressive strategies. In the past, HHF had avoided the use of branch locations. It was estimated that a branch location required a capital outlay of between $75,000 and $150,000, depending on the cost of the land. In addition to the large capital outlay, John Curry, chairman of the board, did not like the idea of having three or four employees in any HHF branch with no senior officer around to supervise. Curry also felt HHF's policy of paying the highest interest rates on savings allowed by law eliminated the need for a branch network. At the end of 1977, Hoosier Home Federal had one branch and a main office. The branch was created when HHF moved into a newly constructed main office in 1969. After the move it was decided to keep the old main office as a branch.

4 During 1977, Irvin Spears was able to convince his uncle that if HHF did not provide branches for its customers, it would eventually lose customers to the three rival savings and loan associations in the area (see Exhibit 2). HHF opened its second branch in early 1978 in the fashionable western end of the county. Since its opening the branch had been very successful at attracting new customers. More important, 40 percent of HHF's business was coming from residents of the two adjacent counties.

5 During 1978, Spears developed a master plan for branch development which called for the addition of two new branches each year for the next five years. Two branches, to be opened in early 1979, were presently under construction—one in each of the two adjacent counties.

exhibit 2

Assets of tri-county banks and savings and loans for 1975, 1976, and 1977; and number of offices as of December 1977

Institution	*Total assets ($ millions)* 1975	1976	1977	*Number of offices 1977*
American Bank and Trust Bank	$229	$251	$286	7
Citizens Trust Bank	227	257	295	5
Farmers Federal Savings and Loan	126	137	150	1
First National Bank	594	631	716	12
First Federal Savings and Loan	139	193	262	13
Hoosier Home Federal Savings and Loan	145	154	170	3
Merchants and Investors Bank	118	129	136	4
Peoples State Bank	74	89	86	2
Pioneer Federal Savings and Loan	87	102	116	3
Second National Bank	581	615	654	10

6 A second newly adopted strategy that had contributed to HHF's growth was the use of TV advertising. In the past HHF advertised exclusively in the financial section of the *News-Reporter,* a regional newspaper. The ads emphasized to the saver that HHF paid the highest interest rate allowed by the regulatory authorities. Curry considered TV advertising a waste of money and did not believe that it could attract new customers. However, Spears, with the help of Richard Holland, HHF's president, prepared a very persuasive presentation during 1977 that convinced Curry and the board of directors to try TV advertising on a trial basis. Spears was assigned the task of working with HHF's advertising agency to develop a TV campaign. The ads began in the fall of 1977 and were judged by management to be successful in creating consumer awareness of Hoosier Home Federal. After reviewing the campaign's success, Curry agreed to spending most of HHF's advertising budget for TV spots.

John Curry

7 Hoosier Home Federal was headed by John Curry, chairman of the board of directors. The Curry name had been affiliated with Hoosier Home Federal ever since it was established in 1899. Curry was a highly respected member of the financial community and possessed a great deal of knowledge about the savings and loan industry. He was regarded by the officers of HHF as an expert in his field. However, he was a very autocratic individual. It was often said that Curry believed there were two ways of doing things: his way and the wrong way. If he believed in a new idea, it was implemented; if he did not like an idea, it was dropped.

8 One case where his unilateral decision making may have proved costly was in data processing services. In 1976, HHF had to decide whether to update and modernize its existing data processing system, which it rented,

or to buy computer serivces from an outside source. After listening to a sales presentation by Federal Home Loan Bank (FHLB) representatives, Curry decided to rent time from the FHLB. The FHLB representatives said they would be able to handle all of HHF's computer needs within nine months. No outside experts were consulted to determine what HHF's data processing requirements were and no systematic evaluation of the FHLB proposal was conducted to determine whether the service HHF would receive would really be adequate. Several of the association's officers did express skepticism at the FHLB proposal but were ignored.

9 As it turned out, the data processing tie-in with the FHLB quickly proved unsatisfactory. Only half of Hoosier Home Federal's data processing could be accommodated by the FHLB and the service was slow; the rest continued to be handled in-house on HHF's outdated equipment. As a consequence, Hoosier Home Federal found itself burdened with the costs of using and maintaining two different data processing systems. To correct this, HHF had plans underway to modernize its own system. The Federal Home Loan Bank had been informed that as soon as HHF's new system was operational, their arrangement on computer services would be discontinued.

10 In addition to making the key decisions, Curry also believed in maintaining control over the board of directors. Curry handpicked the members of the board of directors; all of the present board members were respected businessmen in the county and most of them had retired from full-time positions at firms in the area. Their average age was 67 years.

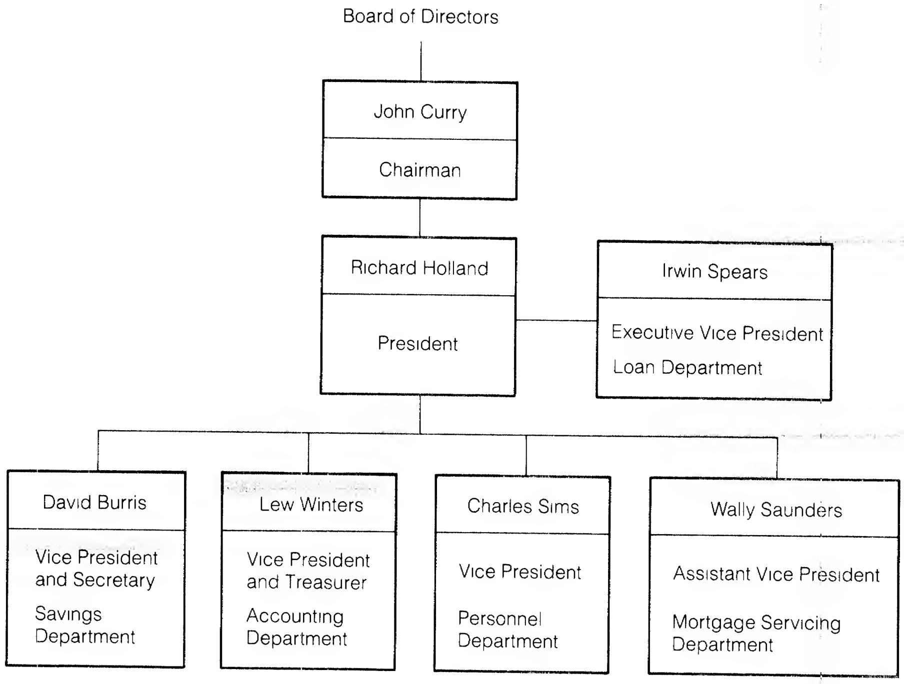
11 The board met once a month and had the final say on any decision affecting the association. A major complaint by the loan officers was the number of loans that had to be taken to the board for approval and any loans that did not meet the guidelines had to be approved by the board. This policy required each loan officer, during peak loan demand, to prepare 15 or 20 loan files for the board's review. Board approval also had to be obtained for all nonroutine expenditures over $100.

Richard Holland

12 Holland held the title of president and supervised the daily operations of HHF's five functional divisions (see Exhibit 3) for HHF's organizational chart). In the past this did not require a great deal of responsibility, but as Curry neared retirement more of the operating decisions were being made by Holland.

13 Holland had a degree in agriculture from Purdue University. Prior to joining Hoosier Home Federal in 1969, he had worked as a branch manager for a commercial bank for 10 years. Holland's first assignment was as a mortgage loan officer. He progressed rapidly and was made a vice president in 1972; six years later he was promoted to executive vice president. In 1978, when Curry assumed the title of chairman of the board and chief executive officer, Holland was made president.

exhibit 3
Organization chart



14 Holland's personality contrasted with Curry's. Holland was very friendly with everyone and never lost his temper with employees. He was very open minded and could be persuaded to adopt new methods and ideas if they were substantiated by convincing data. Holland had been instrumental in carrying the banner of change in the board of directors meetings—Holland and Curry were the only officers of HHF that were members of the board.

15 Much of Holland's success at Hoosier Home Federal was due to his ability to work successfully with Curry. Holland knew when to push and when to keep quiet, and he clearly enjoyed Curry's confidence. Holland recognized that Curry was grooming his nephew, Irwin Spears, to eventually assume the leadership of Hoosier Home Federal. This did not bother Holland, however, because he planned to retire in four years and did not feel Spears would have enough experience to take over the top spot before then. Curry was planning to retire in January 1980 when he reached the age of 70.

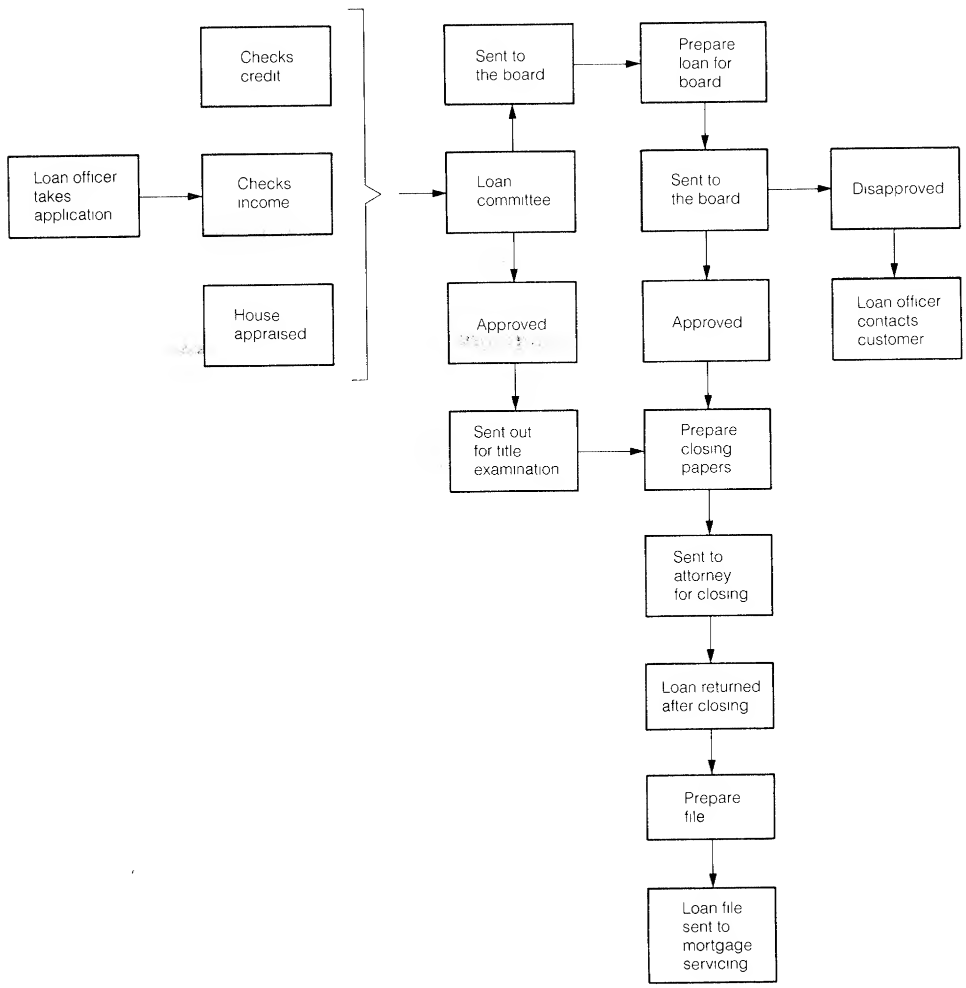
16 In his interview with the casewriter, Holland indicated that his worst experience as president at Hoosier Home Federal concerned the dismissal of Breedlove, age 57, who had been an assistant vice president in the mortgage lending area and who had been employed at HHF for 15 years. Breedlove had been fired at the insistence of Irwin Spears. Spears wanted Breedlove out of the way in his attempts to revise and improve HHF's mortgage lend-

ing procedures. In Holland's view, Breedlove had been a good employee—a bit crotchety perhaps, but amiable and hardworking. Holland had been greatly disturbed at firing an employee whom he had worked with as a fellow loan officer—especially under the circumstances.

The loan division

17 HHF's loan division was responsible for generating loans for the deposits brought in by the savings department. Loan officers were responsibile for a loan from the time of application until it was closed and a permanent file made. Exhibit 4 is a flowchart of a loan officer's duties. During the winter

exhibit 4
Flowchart of a loan officer's duties



months, when loan demand was slack, the loan officers were assigned a number of special projects, such as working on branch applications or conducting efficiency studies of the loan division.

18 Irwin Spears was in charge of Hoosier Home Federal's loan division. He had a B.A. degree from Butler University and an M.B.A. from Indiana State University. After graduation, he served two years in the Peace Corps before joining HHF in 1975. At the outset, Spears worked briefly in several of HHF's different departments to gain an overall knowledge of the business. He was soon assigned to the loan division as a loan officer.

19 Shortly after Spears joined the loan division, conflicts began to develop between him and the other loan officers. The loan officers resented Spears sometimes leaving work early to play golf and taking extra-long lunch hours with friends at the Riverview Country Club. Holland justified Spears' activities to the other loan officers by pointing out that he worked late several nights a week.

20 In January 1977, Spears was promoted to vice president in charge of the loan division. Two months later, Spears was the driving force behind the termination of Breedlove. Prior to his dismissal, Breedlove had indicated that he could not make ends meet with the salary he was receiving. Spears refused to recommend a raise for Breedlove; instead Spears had indicated to Holland that he could not gain complete control over the loan division unless Breedlove was removed.

21 During the fall of 1977, Spears set out to improve the operations of the loan division for the 1978 lending season. Most of HHF's home mortgage loans were made between March 1 and September 30, during the height of the residential real estate market. Spears took a number of steps to increase the efficiency of the loan division. A new phone system was installed that allowed secretaries to answer the phones of the loan officers. Two new secretaries were hired so that each loan officer would have a secretary. Electronic calculators were purchased for the loan officers that enabled them to avoid the time-consuming task of doing calculations by hand. Plans were also made to bring a branch manager and several management trainees into the loan division during peak periods to help out the two new loan secretaries. Spears made one final alteration of the operation of the loan division. In an attempt to avoid risky loans on low-quality housing, underwriting standards were raised. Under the new standards a house had to sell for at least $15,000 and be located out of a declining neighborhood before it would qualify for a loan.

22 In addition to the preceding changes in internal operations, Spears also attempted to improve HHF's image among the real estate brokers and builders in the area. Over the years, HHF had gained a reputation among builders and realty firms for giving short appraisals (where a house is appraised for a value less than its selling price). As a result, builders and real estate agents usually steered their customers to HHF's competitors. Spears discussed this problem with the firm that did HHF's appraising and received the firm's assurance that the problem would be eliminated.

23 A second step Spears took to improve HHF's relationship with realty firms and builders was the development of a newsletter. The newsletter was sent out monthly to real estate brokers and builders and highlighted Hoosier Home Federal's lending policies and the current mortgage interest rates. The response from the builders and realty firms was very favorable.

24 The addition in August of two new loan officers was particularly beneficial. Both Davis and Smith were young and aggressive individuals. Davis had completed two years of college and had worked at a small savings and loan in Chicago for three years prior to joining Hoosier Home Federal. Smith, on the other hand, was a spring 1977 graduate of Ohio State University with a major in finance, and did not have any previous business experience. Both individuals were hard workers and took pride in doing their best.

25 In organizing the staff of the loan division. Spears adhered to the philosophy that competition increases productivity. With this in mind, he established two teams made up of a loan officer and a secretary. Each team was assigned to specific volume of loan closings. Data was kept on each team's performance and a total of the loans closed by each loan officer was announced at the end of the month. The team system worked out better than had been expected. During May 1978, Smith and Davis closed $2.4 million of loans and took a total of 135 loan applications. This was an all-time record for the loan division, and Spears was very satisfied.

26 The large volume of loans in May had required Davis and Smith to work 70 to 80 hours a week. Very rarely did one of them stay after work without the other also staying. Neither loan officer was compensated for the additional time he spent after work. Both loan officers realized that their future success at HHF was dependent on how the senior officers viewed their performance.

27 In early June several problems came to the attention of Spears. While reviewing a few of the loans that had been closed in May, Spears discovered a number of mistakes. As a result of these findings he decided to take a sample of 10 loans from the loans closed by each loan officer during the month of May. Upon investigation, Spears discovered Davis had made mistakes on 4 of the 10 loans he closed while Smith had made no mistakes. Three of the mistakes Davis made were of a serious nature. After talking to the loan officers about the situation, it became apparent they were both under a tremendous amount of pressure. Smith indicated that he had probably made a number of mistakes on files that were not checked.

28 Sims, vice president of personnel, brought a second problem to the attention of Spears. Sims informed Spears that Davis was turning off his phone at the switchboard so that he could get his work done. Sims said the switchboard operator came to him in tears recently because of the profane language customers would use when she told them Davis was not available. After talking to Smith, Spears discovered that Smith and a management trainee had been answering all of the information calls and had even been receiving calls from Davis's customers.

29 The final problem brought to the attention of Spears also came through Sims. Sims had indicated that Smith had come to him, disturbed about the situation in the loan division. Smith had two gripes that he wanted to get off his chest. The first gripe Smith had concerned the use of branch managers and management trainees in the loan division during peak periods. He thought it was an asinine idea, but was scared to tell Spears that one of his ideas was stupid. Smith said he was under enough pressure without having to train someone to handle mortgage loans. He indicated he spent more time fixing mistakes made by the branch manager than it would have taken for him to close the loans himself.

30 The second complaint Smith made concerned Davis. Smith said that during the month of May, Davis and he were running neck and neck in loan closings. Each loan officer knew whoever closed the most loans would hold the all-time record for loans closed in one month. Toward the end of May, Smith did not receive any title examinations from the title company and as a result closed only $1.13 million in new home loans. Davis went on to close $1.32 million in loans. In early June, Smith called the title company to find out why he was not receiving any title reports. The title company informed Smith that Davis had told them to expedite his examinations. This action had caused a delay in the processing of the title searches requested by the other loan officers. Smith had indicated that Davis and he had almost come to blows over the matter one night when they were working late. Smith felt that he had been cheated out of the loan-closing record.

31 During the next weekly loan division meeting Spears went over the problems that had come to light. He emphasized the importance of accuracy in closing loans and indicated that everyone was working for the same team. He also warned loan personnel never to take complaints about the operations of the loan division to anyone except himself. In order to eliminate the mistakes, Spears established a policy of having loan officers review the work of fellow loan officers before the loan was closed. He also hired a new loan officer in July to take the pressure off Davis and Smith. The new loan officer was a 1974 graduate of Indiana University. His addition brought the loan division up to three full-time loan officers, a management trainee, and a branch manager.

32 These changes were very effective. Mistakes declined; Davis and Smith were not required to work as much overtime. But the improvements turned out to be temporary. During the spring, Spears found it necessary to fire two secretaries for not performing their duties. One was terminated in February and her replacement was fired in June. Davis was also terminated in August, after he had argued with Spears over the quality of his work. Two weeks after Davis was fired, Smith gave his notice and said he had taken a job with a large commercial bank in Indianapolis.

33 Outside the present turnover problem in the loan division, Spears had compiled an impressive track record during his short tenure at HHF. He had developed a program to establish branches and was instrumental in establishing more effective advertising campaigns. In addition, Spears was behind

reorganizing Hoosier Home Federal into separate operating divisions. Prior to the reorganization, the duties and functions of HHF's officers had not been clearly separated and defined; the overlapping and fuzzy lines of authority had created a lot of internal confusion and bottlenecks in paperwork.

Treasurer's department

34 The treasurer's department was headed by Lew Winters, a 1955 graduate of West Virginia University. Prior to joining HHF in 1969 Winters worked as a CPA for one of the Big Eight accounting firms. Winters occupied the position of vice president and treasurer of HHF and was responsible for the accounting function and cash planning in the association.

35 The accounting functions at HHF were considered to be efficiently performed. Winters believed in training the people in his department to do two or three different jobs in order to avoid any disruption if an employee decided to quit. In the last two years the accounting department had lost only one employee. The employee who resigned was a degreed accountant who took a more rewarding position in a local manufacturing firm. After attempting for six months to replace this individual with a person of equal caliber, an employee was shifted from mortgage servicing to fill the opening.

36 The employees in accounting were very loyal to Winters and many considered him to be the ideal boss. Winters had also developed good relationships with Davis and Smith who worked in the loan division. Outside the accounting group, however, Winters was considered to be very short tempered—he was not above swearing at employees who made mistakes. Winters was disliked by a large number of employees in the other divisions largely because of his position as financial watchdog for the association. For instance, Winters had instituted a strictly enforced policy that tellers could not leave work at the end of the day until they balanced their cash or found the mistake. In one case with a new teller, three employees worked until 8:30 at night helping the teller balance. Employees normally work from 9 A.M. to 4 P.M.

37 During 1978, Winters was concerned about HHF's liquidity position. Rising interest rates during the summer of 1978 had caused many customers to withdraw their savings to place them in higher-interest-bearing investments elsewhere. Winters had brought the deteriorating liquidity position to the attention of Curry, and suggested that HHF slow down its mortgage lending activities. However, Curry ignored the suggestion and continued to allow the loan division to operate at full capacity. For a period of two months, HHF was the leading savings and loan in the tri-county area in making loans.

38 At the end of July, the Federal Home Loan Bank Board finally forced Hoosier Home Federal to curtail making home loans. The FHLB had been lending money to HHF in order to help it maintain its liquidity position. On August 25 the FHLB took steps to improve HHF's liquidity position. One of

the steps strongly suggested was a moratorium on all lending activities. Winters was very disturbed that the situation reached the point where outsiders were telling Hoosier's management what had to be done.

Personnel

39 Sims was vice president in charge of the personnel division. He joined HHF in 1967 following his graduation from Western Michigan University where he majored in psychology. Sims was a very dedicated employee who was very conscientious about doing a good job.

40 Sims was responsible for hiring new employees and terminating those who did not work out. He was also responsible for resolving all personnel problems that arose in the association, except for those that occurred in the loan division. Spears insisted upon the right to hire and fire all the employees under his supervision—an insistence which produced conflicts between Sims and Spears. Spears believed that if an employee was not doing a good job, he sould be terminated and a new employee hired. Sims, on the other hand, believed it was necessary to work with the employee in an effort to resolve the problem. Sims felt termination should be used only when other measures failed.

41 One of HHF's long-standing personnel policies was to start new employees off at a relatively low salary. All salary scales and raises were approved by the board of directors. The salary scales for nonofficer-level positions at HHF were between 10 and 15 percent lower than other financial institutions in the tri-county area. However, Curry was proud that HHF had been able to maintain proportionately lower salary expenses than other savings and loans in the area.

42 Sims took pride in Hoosier Home Federal's accomplishments in the area of equal employment and advancement of women. The assistant savings division officer, a branch manager, and two assistant branch managers were women. All four of these employees started their careers as tellers and had worked their way up. HHF had more women in middle-management positions than any other savings and loan in the area. Sims was also pleased with two personnel development programs which he instituted. The first program was an employee education program whereby HHF paid tuition for any employee who completed courses sponsored by the American Institute of Savings and Loan Associations. A total of 20 employees, 30 percent of HHF's work force, had participated in this program during the last five years.

43 The second program Sims had developed was a management training program. Under the program, management trainees were rotated through the different divisions in order to give them a broad exposure to HHF's various operations. In the future, he hoped new loan officers and branch managers would be chosen from the individuals who had completed this program.

Savings division

44 David Burris, who was in charge of the savings division, had been with HHF since 1954. He was a graduate of Ohio State University and had a great deal of experience in the savings and loan industry. Prior to the reorganization Burris had split his time between mortgage lending and savings, but after the reorganization, he had been placed in charge of the savings division. Burris was a quiet and reserved type of person. He made a good first impression, enjoyed meeting people, and understood the importance of HHF's employees furnishing customers with friendly efficient service. Customers often came to Burris wanting him to make exceptions on deposits and withdrawals, even though the exceptions would break FHLB regulations. Burris' job was made easier by the fact that HHF always offered the highest interest rate allowed on each type of savings account. The success of the new branch, which was opened in early 1978, helped to bring in a substantial amount of new savings deposits.

45 Burris, in conjunction with Holland and Spears, established two new programs in 1977 which were very successful. The first program developed was a save-by-mail savings plan. Under this plan, HHF paid postage both ways for customers who mailed in deposits. This feature was very attractive to savers in rural areas who were not able to obtain an equally high return on their savings at banks or who found it more convenient to make their deposits via mail.

46 The second innovative program that was established in 1978 was a dial-a-check savings plan. Under this plan savings customers could call or write the assistant savings officer and authorize a transfer from their savings account to their checking account at a commercial bank. This program was very attractive to customers who held large balances in noninterest-bearing checking accounts. Hoosier Home Federal paid interest on its regular pass book accounts from the day of deposit until the day of withdrawal.

47 In addition to these new programs, Burris was optimistic about the impact of opening more new branches. Savings that came in through branch locations were, on average, deposited in lower-yield savings accounts; experience showed that new deposits at the branch offices were mainly in regular passbook accounts. The main office had a very high proportion of new deposits in savings certificates that carried generally higher interest rates. The overall average ratio of interest which Hoosier Home Federal was paying on its savings accounts was crucial because it directly affected the interest rate which had to be charged on new mortgage loans.

Mortgage servicing

48 The mortgage servicing department was run by Wally Saunders. Saunders had completed a two-year course in computer programming at United Electronics Institute before joining HHF in 1972. He was promoted to his present

position in 1975 after spending three years in data processing. Saunder's department was responsible for collecting payments on the mortgage loans and for, in general, servicing the mortgage loan accounts. This included handling escrow agreements on homeowners insurance and property taxes, making sure monthly payments were made on schedule, and so on. The operations of mortgage servicing usually proceeded very smoothly, but in 1978 a few problems did develop.

49 In the summer of 1978, when Saunders was preparing to pay the property tax bills, he discovered his division did not have information on over 200 loans. Upon investigation he discovered that the loan division had been closing loans, and then not preparing a file. After talking to Curry, Saunders learned that the loan division had estalished closing loans as its top-priority duty and everything else came second. After Saunders explained the problems, this policy created for mortgage servicing, Curry assigned several people to assembling files.

50 The only other difficulty that occurred in this division during 1978 was the departure of three employees. At the end of July, three of the seven clerks were new. Of the clerks replaced, two of them had quit and the third was fired. The majority of the clerks, tellers, and secretaries at HHF were younger than 25.

51 Although Saunders expressed satisfaction with his position at Hoosier Home Federal, he was uneasy about his future. He felt that Spears looked down on him because he was not a college graduate. Saunders knew that both Spears and Holland preferred to have college graduates in upper management positions.

The future

52 As of late 1978 Holland was contemplating what steps to take regarding the problems that cropped up over the summer. He also realized that he needed to look ahead to 1979 and to map out some operating improvements. As he thought more about it, he saw three areas of particular concern:

1. The turnover problem both at the management level and among the staff employees.
2. How to deal with Irwin Spears, who in some respects had made some very positive contributions, but who on other fronts had been something of a disaster.
3. The whole idea of growth—the additional branches which were planned over the next five years offered some exciting possibilities for HHF, but he was not convinced that the association was organizationally equipped to cope with the changes that more branches would bring.

case 21

Dr Pepper Company

1 America's most misunderstood soft drink, Dr Pepper, is into the soft-drink big time now. It is virtually tied with 7up as the number three soft drink, behind the leaders Coca-Cola and Pepsi-Cola, and 1980 marked the 23d consecutive year of increased sales and earnings (see Exhibit 1). While its rapid national emergence is a relatively recent phenomenon, Dr Pepper's beginnings can be traced to 1885. The gradual evolution of Dr Pepper occurred as follows:

exhibit 1
Gross revenues, margin, and net income, 1968–1980

Year	*Gross revenues ($ millions)*	*Operating profit margin (percent)*	*Net income ($000)*
1968	$ 41.9	19.7%	$ 4,108
1969	49.5	19.1	4,642*
1970	57.4	17.7	5,629
1971	63.6	18.6	6,772
1972	77.4	19.0	8,102
1973	98.9	17.0	9,736
1974	128.3	13.5	9,902
1975	138.2	16.4	11,904
1976	151.8	18.4	15,530
1977	226.8	16.4	20,322
1978	271.0	15.1	23,565
1979	291.8	14.4	23,609
1980	333.2	14.3	26,543

* After 5 cents a share nonrecurring loss on cyclamates.
Source: Moody's *Handbook of Common Stocks*, Fall 1980.

2 1885—Dr Pepper formula was perfected and introduced by Robert S. Lazenby, eminent beverage chemist in Waco, Texas. Drink was first served in Wade B. Morrison's old corner drugstore in Waco.

3 1890—Dr Pepper was being bottled at numerous points in Texas. Syrup was being hauled from Waco by Wells Fargo Express. The first corporate owner of the Dr Pepper formula and Dr Pepper trademarks was a Texas corporation, Artesian Manufacturing & Bottling Company of Waco. The present Dr Pepper Company emerged from consolidations of the Artesian corporation with several minor firms.

4 1921—J. B. O'Hara, young U.S. Army engineer from Duryea, Pennsyl-

This revised edition of an earlier case study was prepared by George S. Vozikis, North Texas State University, and Timothy S. Mescon, Arizona State University.

vania, was married to Lazenby's daughter and joined his father-in-law in the business. He later became president and chairman of the board and provided the spark that launched the company on its road to success.

5 1923—Lazenby and O'Hara moved the company from Waco to Dallas and established a corporation under the laws of the state of Colorado on July 5.

6 1927—O'Hara discovered the findings of Dr. Walter Eddy. Ph.D of Columbia University, which proved that sugar provided energy and that the average person experienced a letdown during the normal day at 10:30 A.M., 2:30 and 4:30 P.M. Thus, O'Hara reasoned that Dr Pepper, because of its sugar content, would supply energy, and taken at 10, 2 and 4 o'clock, would enable one to avoid these fatigue periods. So, Dr Pepper's slogan "Drink a Bite to Eat at 10, 2 and 4 o'clock" became famous and is still recognized as one of the most significant and valid soft-drink slogans ever.

7 1930—By 1930, Dr Pepper distribution had spread throughout the South and into the Midwest. A few bottlers served the West Coast. There were approximately 400 bottlers distributing Dr Pepper. Some were relatively small but provided thorough distribution in many urban and rural areas.

8 1931—H. S. Billingsley joined the company as auditor. He became secretary, a vice president in 1947 and in 1951 a member of the board of directors; 1964, executive vice president; 1966, president and chief operating officer (CEO); 1967, president and chief executive officer; 1969, chairman of the board and chief executive officer; 1970, chairman of the board. He retired from the company in 1974 and served on the board of directors until 1975.

9 1940–45—O'Hara's theory that Dr Pepper provided energy proved to be a lifesaver during World War II, when sugar rationing threatened to curtail operations of the soft-drink industry. His theory, along with other evidence supplied by industry leaders, prompted the War Rationing Board to rescind an earlier ruling to disallow any sugar quotas for the manufacture of soft drinks.

10 1942—W. W. Clements joined the company as zone manager. He moved up to become vice president–marketing in 1957; executive vice president and member of the board in 1967; president and chief operating officer in 1969; 1970, president and chief executive officer; 1974, chairman of the board, president, and chief executive officer; 1980, chairman of the board and chief executive officer.

11 1946—Dr Pepper Company stock was listed on the board of the New York Stock Exchange under the symbol DOC. This was an important milestone in the success of Dr Pepper and resulted in a broadened ownership of stock in the company.

12 1950—Although growth had been conservative through the years, it had been solid. Distribution gradually expanded with bottling plants serving wider areas. The number of plants had not increased but the area served was greater. Growth in the company's structure became more pronounced, and

Dr Pepper weathered a number of economic storms. A modernized logo design without the period after Dr was introduced for bottle crowns. Though the logo has evolved further, the period has never reappeared.

13 1956—Wesby R. Parker joined Dr Pepper Company. He was responsible for important changes including a management development program and the introduction of Hot Dr Pepper which shocked many people. Today, Hot Dr Pepper is recognized as a major asset to the company and the only carbonated soft drink that has had any success as a hot beverage.

14 1960—By now, Dr Pepper had become well established as the growth product in the industry and one of the major soft-drink brands in America. Its national distribution was better than 75 percent and gaining. Territory consolidation, plant mergers, and new franchises continued to expand product availability and improve Dr Pepper's market position. Advertising was spread nationwide to reach unfranchised areas for Dr Pepper's introduction.

15 1962—Diet Dr Pepper was introduced. Other diet soft drinks already were on the market; some with negative experience due to inferior taste. Extensive research had gone into Diet Dr Pepper to make sure it was right. The delay proved worthwhile. Diet Dr Pepper was considered more identical in taste to the original product than many other leading brands. It achieved wide popularity and contributed substantially to Dr Pepper's annual sales.

16 1963—A major roadblock to domestic franchise expansion was removed when a U.S. district court ruled that Dr Pepper was not a cola. Bottlers formerly restricted by agreements with cola franchisors from producing and selling two cola brands were able to join a growing network of Dr Pepper franchise operations with protected territories for manufacturing and distributing Dr Pepper products.

17 1970—Dr Pepper was introduced in the New York City market, largest soft-drink consuming area in the world, with some 18 million people. The drink was introduced by Dr Pepper Company franchisee, the Coca-Cola Bottling Co. of New York, Inc. Dr Pepper introduced "Misunderstood" ad campaign developed by Young & Rubicam.

18 1971—After extensive research, Sugar-Free Dr Pepper, formulated with saccharin as a sweetner, was introduced replacing Diet Dr Pepper due to the FDA ban on cyclamates imposed in 1969. Sugar-Free Dr Pepper quickly grew in popularity to become the leading diet soft drink in many markets. Current logos and colors for Dr Pepper and Sugar-Free Dr Pepper were introduced.

19 1972—Growth continued at the rate of 15 percent per year as Dr Pepper became the fourth largest-selling soft drink in America.

20 1973—Two important developments that made 1973 a significant year in Dr Pepper's progress were: (1) Domestic franchising was virutally complete; less than one half of 1 percent remained unfranchised; (2) Dr Pepper made its first major move into the international market with its introduction in Japan by the Tokyo Coca-Cola Bottling Co., Ltd. Negotiations with this company formed a joint-venture company, Dr Pepper Japan, Ltd.

21 1974—The "Most Original Soft Drink" advertising campaign was introduced to make new customers aware of Dr Pepper's unique taste.

22 1976—Domestic growth continued at a record-setting pace as Dr Pepper moved into Malta, Europe, and surveyed controlled foreign growth. Metric packaging was introduced by several bottlers. One- and two-liter returnable bottles were well accepted in the marketplace.

23 1977—Acquisition and development of major franchises in Houston, Texas, and southern California, as construction continued on a $21 million Dallas-Fort Worth production facility, laid the groundwork for increased corporate growth. John B. Connally was elected to the board of directors following the death of Jack Vaughn, a director since 1960. For the 20th consecutive year, sales and earnings reached all-time high levels at $226.8 million and $20.3 million, respectively.

24 1978—Record sales of $271 million produced record net earnings of $23.5 million and "Peppers" began popping up all over as Dr Pepper successfully introduced "Be a Pepper" advertising to receptive audiences. Dr Pepper Company concluded its arrangement with Dr Pepper Japan, Ltd. and set up Dr Pepper Japan Company to enable greater franchise opportunities in the Far East. Expansion into new international markets brought Dr Pepper to Jordan and Guatemala. San Diego assets of the southern California franchise were sold to an independent franchisee and increased marketing efforts were realized for the company's largest subsidiary plant market covering the counties of Los Angeles, San Luis Obispo, Santa Barbara, and Ventura. This southern California territory encompasses a trade population of 9.5 million. Dr Pepper was made available in PET (polyethylene terephalate) plastic, two-liter bottles. Governmental concern about the safety of saccharin developed into legislation placing an 18-month moratorium on banning saccharin and requiring cautionary labeling on all products containing the artificial sweetener, including Sugar-Free Dr Pepper. Consumers perceived Sugar-Free Dr Pepper to satisfy a need for no-sugar diets and continued to purchase the product.

25 1980—Dr Pepper became the number three selling soft drink in the United States as net sales of $333 million achieved another record. Charles L. Jarvie became the 10th and youngest (43) president of Dr Pepper Company in February. The board of directors also elected Jarvie chief operating officer and a member of the board. W. W. Clements remained chairman of the board and chief executive officer. "Be a Pepper" continued to gain national attention via advertising and promotion programs.

26 Purchase of the Dr Pepper Bottling Co. of Corpus Christi, Texas, makes the Gulf Coast plant the company's sixth wholly owned subsidiary. In July, 1980, then President Jimmy Carter signed into law the Soft Drink Interbrand Competition Act thereby upholding the integrity of the industry's franchise system. Richard A. Zimmerman, president and CEO of Hershey Foods Corp., was elected to the board of directors. The expansion of international marketing took Dr Pepper to Sweden, Nigeria, and Chile.

Management

27 Dr Pepper is professionally managed. It has some family control. Virginia Lazenby O'Hara, daughter of the founder, owns approximately 9 percent of the stock. Ms. O'Hara's late husband was president, then chairman, from 1933 to 1961. He was succeeded by Wesby R. Parker, who joined the firm after some years with General Foods. Three of his top executives died in an airplane crash in 1964, and Parker died in 1967. He was succeeded by Hascal Billingsley. All these presidents came from the financial or operations function.

28 The current chairman, Woodrow Wilson Clements, is the first with a major background in marketing. "Foots," as Clements likes to be called, studied at Howard College and graduated from the University of Alabama (1935), where he played football. He went from route salesman to sales manager of the Dr Pepper Company in 1942. He was successively district manager, sales promotion manager, assistant manager of the bottler service, and general sales manager, 1951–1957; vice president, marketing, 1957–1967; executive vice president and director, 1967–1969; president and chief operating officer, 1969; president and chairman, 1970.

29 Foots Clements reflects his rural Alabama upbringing in his folksy approach to employees and bottlers. He relishes telling tales. Clements is the supersalesman who enjoys drinking the company product hot or cold. He predicts that Dr Pepper will exceed the sales of Coca-Cola, probably within 20 years.

30 In February 1980, Charles L. Jarvie was elected president, chief operating officer, and a director of Dr Pepper, succeeding W. W. Clements. In an interview with *The Wall Street Journal* on February 27, 1980, Clements said that Jarvie is expected to take over the soft-drink operations of Dr Pepper and also help it find, evaluate, and operate its first food-industry acquisition. "I'm a salesman, not a buyer," Clements said. "I'm delighted to get rid of the day-to-day operating responsibilities." Clements' new role is that of CEO and chairman of the board. Addressing a record number (300) of shareholders at the 1980 annual meeting in Dallas, Jarvie made the following remarks:

> I'm delighted to be here to attend my first of many Dr Pepper stockholders meetings. It represents the start of a long and productive association for me with this outstanding company and I look forward to many more such meetings like this.
>
> As Foots has told you, and as I suspect most of you know, I've been with Dr Pepper only a short time; since March 1st to be exact. I came here after a 20-year career at Procter & Gamble, mostly in marketing, because the facts suggested that Dr Pepper has an unusual potential for significant growth in the 1980s. The prospect of being part of that growth represented an exciting and challenging stimulus and helping to engender the growth is a stimulating challenge.
>
> My first weeks at Dr Pepper have been full as I commenced an intensive, total immersion program delving into all aspects of our business. Frankly, this has left me a little bit limp at times but has been a tremendously positive experience. More

importantly, I can report to you that my initial in-depth experiences have been confirmatory with respect to our business and our people.

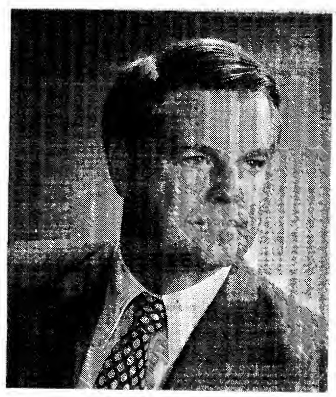
It may be appropriate for me to mention in more specific terms the assets I thought I'd find at this company and which I am in fact finding. There are four and they encompass the integral parts of any business.

First, is a strong organization, I'm used to working with good people. I came from a company full of good people. The people I met during the interviewing process here impressed me a great deal, but as with any top management you expect them to be impressive. You never know what you're going to find in the trenches until you get out there with the people that produce the business.

I have had that experience now in some depth and I'm tremendously encouraged with the quality, dedication, expertise, and enthusiasm of the Dr Pepper organization. It is at least as good as the organization I have been associated with and in many ways is better, fun to work with, and stimulating. I see no limitations on this organization's ability to produce and you have to start with that.

Secondly, we have a strong brand franchise with the consumer and it's important to recognize that there are people out there buying Dr Pepper every day. It isn't as simple as fielding a promotion or television campaign. People have to like your product and they have to like what it represents because if they don't, you can't leverage it. I've been through enough of the numbers and the research available in the company to reassure you that Dr Pepper—the brand, the product—has a very strong and leverageable franchise with the American consumer. That's a great asset for this company.

exhibit 2
Charles L. Jarvie, president and chief executive office, Dr Pepper Company



Third, we have a good financial position. The inflation that's with us is tough on all companies. Dr Pepper's basic fundamental financial position is such that we ought to be able to weather this unfortunate economy better than most and to compete effectively. The company has been well-managed financially and it's a good thing as we go into this era.

And lastly, there has been good forward planning done on the company and more

going on now. There is direction, there is intent, there is philosophy; so there is opportunity. All this adds up to great opportunity and potential for Dr Pepper in the 80s. But, before I paint too bright a picture, let me talk a bit about the other side, because we do face challenges—some might even say dangers—in our immediate future.

The economy is tough and it's impacting on the soft-drink industry. Competition is fierce and it's not going to lessen because as an economy gets tougher and business gets harder to gain, companies start spending more money to try to hold or gain position since they're not getting it from basic market growth. That's going on in the soft-drink business.

Dr Pepper has less total resources than our major competitors, which means we've got to be more resourceful to succeed and grow. Our business in certain regions and countries requires strengthening so challenges abound. I expected that they would and none of them look insoluable and that's because the fundamentals at Dr Pepper are just fine. They look just as good from the inside as they do from the outside.

31 In October 1980 Clements made another move to show his faith in long-time Peppers and to soften the blow to their morale from the arrival of an outsider, Charles Jarvie. He created a new senior vice president level and promoted three of his veteran executives to the new designation: John R. Albers, marketing; Alvin H. Lane, Finance/secretary; and Richard D. O'Connor, corporate bottling plants.

32 The overall management structure of Dr Pepper consists of the following executives:

Board of directors

- W. W. Clements, chairman of the board and chief executive officer, Dr Pepper Company, Dallas, Texas
- Edwin L. Cox, oil and gas producer, Dallas, Texas
- Robert B. Cullum, chairman of the executive committee, the Cullum Companies, Inc. (supermarkets and drugstores), Dallas, Texas
- Raymond H. Cummins, retired, former chairman of the board and chief executive officer, Goldsmith's Department Store, Memphis, Tennessee,

Committees

- Executive committee:
  - Clements, chairman
  - Cox
  - Cullum
  - Hunt
  - Jarvie
  - Thompson
  - Cummins, Alternate
- Audit committee:
  - Cummins, chairman
  - Cullum
  - McNamara
- Employee benefits committee:
  - Cox, chairman
  - Hunt
  - Roberson
  - Thompson

Officers

- W. W. Clements, chairman and chief executive officer
- Charles L. Jarvie, president and chief operating officer
- Robert E. Hannegan,* executive vice president-corporate plants
- Joe K. Hughes, executive vice president-operations
- John R. Albers, senior vice president-marketing
- Alvin H. Lane, Jr., senior vice president-finance and secretary
- Richard D. O'Connor, senior vice president-Texas corporate plants

Board of directors

and former vice president, Federated Department Stores, Inc.

Lamar Hunt, chairman of the board, Kansas City Chiefs Football Club, Kansas City, Missouri, and vice president, Hunt Energy Corporation, Dallas, Texas

Charles L. Jarvie, president and chief operating officer, Dr Pepper Company, Dallas, Texas

Pat W. McNamara, Jr., Dr Pepper bottling companies, Lubbock and Plainview, Texas

William R. Roberson, Jr., chairman and chief executive officer, Roberson's Beverages, Inc. (soft-drink bottling plants), chairman and chief executive officer, North Carolina Television, Inc., Washington, North Carolina

John P. Thompson, chairman of the board and chief executive officer, the Southland Corporation (retail food stores), Dallas, Texas

Richard A. Zimmerman, president and chief operating officer, Hershey Foods Corporation, Hershey, Pennsylvania

*Elected January 22, 1981.
†Retired January 31, 1981.

Committees

Officers

Donald L. Antle, vice president-franchise

Roger R. Baier, assistant treasurer

J. Scott Chase, assistant secretary

Jerry M. Corbin, vice president-key account sales

Charles P. Grier, vice president-manufacturing

Charles L. Hawkins, vice president-marketing services

T. C. Hunter, vice president-administration

David M. Love, vice president-sales

Marvin S. Massey, Jr., controller

W. F. Massmann, vice president-government affairs

C. W. Reeves, vice president-International

Hal L. Stockstill, vice president-Japan operations

Robert L. Stone,† vice president-Canada operations and special markets

L. Dan Thompson, treasurer

Marketing

32 Dr Pepper's business is seasonal, with the second and third calendar quarters accounting for the highest sales volume. It manufactures, markets, sells, and distributes soft-drink concentrates (the basic ingredient for soft drinks) and fountain syrups (concentrate with sweeteners and water added), principally to independent, licensed bottlers in the United States. It also bottles and distributes soft drinks through five wholly-owned subsidiaries and cans soft drinks for sale to licensed bottlers. The company's two principal soft drinks are Dr Pepper and Sugar-Free Dr Pepper.

33 Concentrates are sold by the company to approximately 500 licensed bottlers (included five wholly-owned subsidiaries of the company) which have been authorized under agreements (license agreements) to package and sell carbonated beverages for resale under the trademarks Dr Pepper, Sugar-Free Dr Pepper, and Salute, owned by the company, and to produce syrups for distribution to fountain outlets. Licensed bottlers produce the finished soft drink by the addition of sweeteners and carbonated water. Concentrates are also delivered to contract canners, some of which are also licensed bottlers, which can Dr Pepper soft drinks for sale by the company to its licensed bottlers.

34 Fountain syrups are sold to licensed bottlers, to wholesale distributors for resale to fountain outlets, and directly to fountain outlets.

35 The company sets the prices it charges licensed bottlers for concentrate, syrup, and canned products and the price it charges wholesale distributors and direct retail outlets for fountain syrup. Prices charged for products produced by licensed bottlers or sold by wholesalers are established by them or by the retailers distributing such products.

36 Since 1977, Dr Pepper expanded and simplified its sales and marketing organization. The objective has been to make the organization more responsive to bottlers' needs and opportunities in the marketplace. To achieve this objective, the company:

1. Created a brand development department with specific responsibility for developing strategies and marketing plans for Dr Pepper and Sugar-Free Dr Pepper.
2. Combined former bottler and fountain sales divisions into one sales department. As a result, field sales personnel are devoting full attention to development of the total market for Dr Pepper, working closer with bottlers to budget funds for markets with greatest potential for Dr Pepper.
3. Created a trade relations department which, in 1977, developed an executive sales presentation to management of retail food accounts telling the Dr Pepper story and underscoring why it is time to "Make Room for Dr Pepper."
4. Created a youth activities department to more effectively capitalize on Dr Pepper's current strength and potential among young consumers.

Competition

37 The soft-drink industry is highly competitive. The company competes not only directly for consumer acceptance but also for shelf space in supermarkets and for maximum marketing efforts by multibrand licensed bottlers. The company's soft-drink products compete with all liquid refreshments, and with numerous nationally known producers of soft drinks including Coca-Cola, Pepsi-Cola, and 7up, several of which are extremely strong from the standpoint of personnel, products, and finances, as well as regional producers and private label suppliers. Competition may take many forms, including pricing, packaging, and advertising campaigns. Furthermore, there have been, and probably will continue to be, soft drinks produced by other companies which attempt to simulate the unique flavor of Dr Pepper.

38 Dr Pepper fared reasonably well in this tough environment during 1980, again demonstrating the fundamental consumer strength of its product. Unit sales were up 4 percent compared to total industry tonnage growth of 2 to 3 percent—down from the 10 to 15 percent annual rates of recent years. This result indicated that Dr Pepper gained market share in 1980, thus continuing a positive trend. (See Exhibit 3.) A detailed breakdown of soft-drink consumption by brand name is given in Exhibit 4.

exhibit 3
Dr Pepper market share (percent)
U.S. soft-drink tonnage

1975	*1976*	*1977*	*1978*	*1979*	*1980*
5.5	5.8	6.3	6.5	6.6	7.0

39 In 1980, Dr Pepper sales were up in food retail outlets and fountain (e.g., food service) outlets despite a definite softness in the total business of the latter.

40 Progress was made in both Dr Pepper's highly developed southwest markets and its newest markets in the Northeast. In fact, sales in the Northeast were up a substantial 7.4 percent as bottlers in that area were able to secure high levels of retail merchandising support.

41 Both Dr Pepper and Sugar-Free Dr Pepper registered volume gains. The sugar-free product was up an impressive 10 percent, improving its position in the steadily growing diet segment, which now represents about 15 percent of total U.S. soft-drink tonnage.

42 Exhibit 5 presents overall soft-drink industry statistics, while Exhibits 6 and 7 depict the per capita consumption of liquids in general and soft drinks.

43 American consumption of soft drinks increased 314 percent in the three decades after 1950 and beer consumption rose 84 percent, a Pennsylvania State University researcher says.

exhibit 4

Consumption of soft drinks by brand

Company and brand	R1974 Million cases	R1974 Percent market	R1975 Million cases	R1975 Percent market	R1976 Million cases	R1976 Percent market	R1977 Million cases	R1977 Percent market	R1978 Million cases	R1978 Percent market	1979 Million cases	1979 Percent market	1978–79 Percent change
Coca-Cola Cm.													
Coca-Cola	1,088.0	24.4	1,077.0	24.2	1,190.0	24.3	1,290.0	24.5	1,335.0	24.3	1,365.0	23.9	+ 2.2
Sprite	100.0	2.2	110.0	2.5	130.0	2.7	150.0	2.8	158.0	2.9	165.0	2.9	+ 4.4
Tab	96.0	2.2	111.0	2.5	125.0	2.6	137.0	2.6	149.0	2.7	170.0	3.0	+14.1
Fanta	99.0	2.2	93.0	2.1	112.0	2.3	119.0	2.3	112.0	2.0	107.0	1.9	− 4.5
Mr. Pibb	21.0	0.5	35.0	0.8	37.0	0.7	45.0	0.9	46.0	0.8	43.0	0.8	− 6.5
Fresca	28.0	0.6	26.0	0.6	31.0	0.6	28.0	0.5	27.0	0.5	25.0	0.4	− 7.4
Others	—	—	5.0	0.1	10.0	0.2	15.0	0.3	19.0	0.4	61.0	1.1	+21.1
Total	1,432.0	32.1	1,457.0	32.7	1,635.0	33.4	1,784.0	33.9	1,846.0	33.6	1,936.0	34.0	+ 4.9
PepsiCo, Inc.													
Pepsi-Cola	780.0	17.5	775.0	17.4	830.0	17.0	903.0	17.2	969.0	17.6	1,022.0	17.0	+ 5.5
Mountain Dew	47.0	1.1	51.0	1.1	73.0	1.5	100.0	1.9	130.0	2.4	156.0	2.8	+20.0
Diet Pepsi	68.0	1.5	70.0	1.6	90.0	1.9	109.0	2.1	127.0	2.3	142.0	2.5	+11.8
Pepsi Light	—	—	2.0	0.1	25.0	0.5	27.0	0.5	22.0	0.4	24.0	0.4	+ 9.1
Teem	14.0	0.3	13.5	0.3	12.1	0.2	12.6	0.2	14.0	0.3	15.0	0.3	+ 7.1
Others	15.8	0.3	14.5	0.3	15.3	0.3	20.3	0.4	19.0	0.3	18.0	0.3	− 5.3
Total	924.8	20.7	926.0	20.8	1,045.4	21.4	1,171.9	22.3	1,281.0	23.3	1,377.0	24.2	+ 7.5
Seven-Up Co.*													
7up	311.3	7.0	295.5	6.6	305.8	6.3	315.0	6.0	322.0	5.9	320.0	5.6	− 0.6
Diet 7up	27.3	0.6	43.6	1.0	60.0	1.2	62.3	1.2	63.0	1.1	63.6	1.1	1.0
Dixie Cola	9.0	0.2	9.2	0.2	10.0	0.2	10.5	0.2	10.2	0.2	10.0	0.2	− 2.0
Howdy Flavors	1.5	—	1.4	—	1.3	—	1.2	—	1.0	—	1.0	—	—
Total	349.1	7.8	349.7	7.8	377.1	7.7	389.0	7.4	396.2	7.2	394.6	6.0	− 0.4

Dr Pepper Co.													
Dr Pepper	216.0	4.6	217.0	4.9	243.0	5.0	278.0	5.3	299.5	5.4	311.5	5.5	+ 4.0
Sugar-Free													
Dr Pepper	18.0	0.4	28.0	0.6	39.0	0.8	52.0	1.0	60.5	1.1	62.9	1.1	+ 4.0
Total	234.0	5.2	245.0	5.5	282.0	5.8	330.0	6.3	360.0	6.5	374.4	6.6	+ 4.0
Royal Crown Cos.													
Royal Crown	150.0	3.4	153.0	3.4	162.2	3.3	168.0	3.2	164.0	3.0	159.0	2.8	− 3.0
Diet Rite Cola	34.0	0.8	36.0	0.8	40.6	0.8	40.6	0.8	40.2	0.7	38.0	0.7	− 5.5
Nehi and others	56.0	1.2	51.0	1.2	55.6	1.2	53.0	1.0	53.5	1.0	53.0	0.9	− 0.9
Total	240.0	5.4	240.0	5.4	258.4	5.3	261.6	5.0	257.7	4.7	250.0	4.4	− 3.0
Crush International													
Hires, Crush, etc.	127.1	2.8	131.3	2.9	147.1	3.0	161.8	3.1	181.0	3.3	192.0	3.4	+ 3.4
Sun Drop	16.1	0.4	17.1	0.4	20.5	0.4	25.0	0.5	27.0	0.5	28.0	0.5	+ 3.7
Total	143.2	3.2	148.4	3.3	167.6	3.4	186.9	3.6	208.0	3.8	220.0	3.9	+ 5.8
Total (6 companies)	3,323.1	74.5	3,366.1	75.5	3,765.5	77.0	4,123.3	78.4	4,348.9	79.1	4,551.0	79.9	+ 4.7
Others	1,136.9	25.5	1,093.9	24.5	1,124.5	23.0	1,135.7	21.6	1,151.1	20.9	1,148.0	20.1	− 0.3
Grand total	4,460.0	100.0	4,460.0	100.0	4,890.0	100.0	5,259.0	100.0	5,500.0	100.0	5,700.0	100.0	+ 3.6

*Subsidiary of Philip Morris Inc. as of June, 1978

R-Revised.

Source: *Beverage Industry* and John C. Maxwell.

exhibit 5
Soft-drink industry statistics

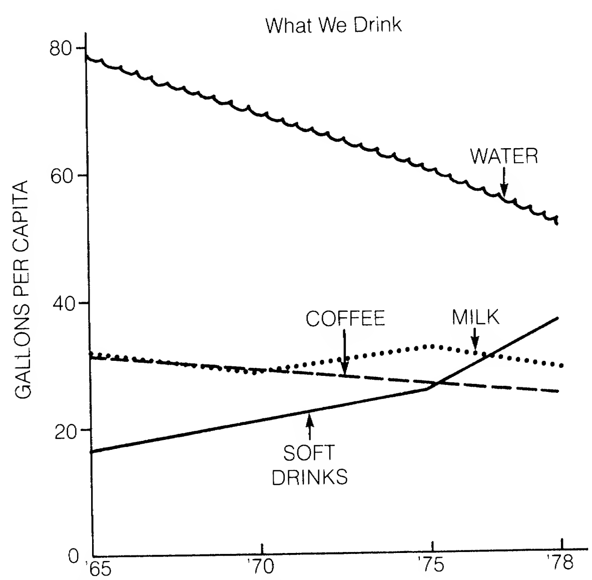
Year	Production (million cases)	Per capita consumption (12 oz. container)	Total wholesale value ($ millions)	Manufacturers' average price (cents per 12 oz.)
1979	3,665	399.6	14,973	17.02
1978	3,490	382.7	13,345	15.93
1977	3,248	359.0	11,527	14.79
1976	2,952	328.7	10,375	14.64
1975	2,610	292.7	9,398	15.00
1974	2,532	286.3	7,827	12.88
1973	2,514	286.4	6,223	10.31
1972	2,361	270.9	5,684	10.03
1971	2,236	258.7	5,347	9.96
1970	2,064	241.9	4,800	9.69

Source: National Soft Drink Association.

44 Dr. Frederick R. Demler said he also found Americans are drinking proportionally more beer at home and less in taverns, while consuming proportionately more soft drinks in restaurants than at home.

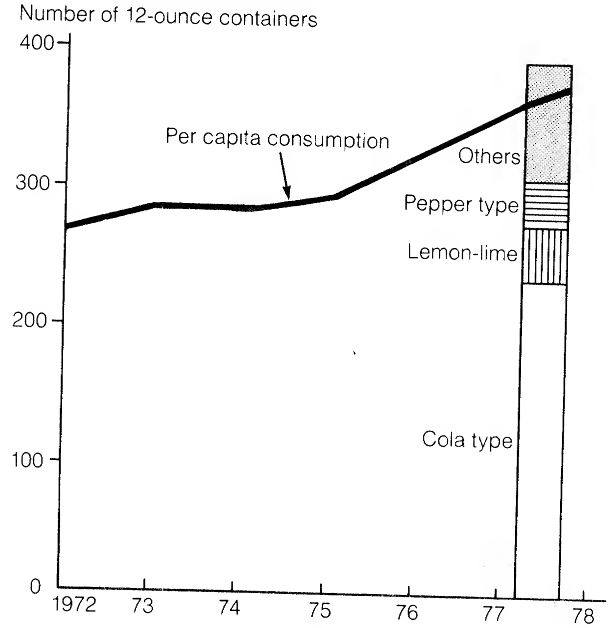
45 Demler said consumer beverage choices after 1950 were shaped by rising incomes, cheap metal containers, and returning war veterans "who were used to discardable cans and helped make them acceptable in a bottle-oriented society."

exhibit 6



Source: National Soft Drink Association.

exhibit 7
Per capita consumption of soft drinks



Source: National Soft Drink Association.

46 In addition to new competition threats from the Coca-Cola's 1980 reformulation of Mr. Pibb, which a coke executive said put it "certainly in the Pepper category," and the sparkling waters of the Perrier type, Dr Pepper has to contend with a discounting war. Industry observers say discount sales contribute 40 percent to 80 percent of unit volume for many bottlers. "Discounting," says Sidney Mudd, chairman of Joyce Beverages, a New York area 7up and Royal Crown bottler, in a 1980 article in *The Wall Street Journal,* "has gotten out of hand. Price promotions are good, but when they're as constant as they are now, they cheapen the product in the mind of the consumer." This practice, also known in the industry as "dealing," can leave an unpleasant aftertaste—weakened brand loyalty—that worries the whole soda-pop industry.

Fast-food/fountain, vending

47 Dr Pepper is available in 35 percent of the total fast-food/fountain accounts. This is an increase from an estimated 30 percent availability in 1976. These accounts rely primarily on five-gallon tanks for receiving and dispensing fountain products to their customers. To improve Dr Pepper's availability in these accounts, the company has been testing a tank distribution program (TD system) for the past two years.

48 Virtually all of the major franchisors currently offer incentives for purchases of vending machines. They generally take the form of percentage rebates on all machines over a minimum or a percentage of the price of the unit.

49 Dr Pepper has come up with a support program which not only offers the incentive, it also assists the bottler/canner by providing financial assistance. By financing through Dr Pepper, the firm would save two ways. First by combining all orders, Dr Pepper orders the vending machines in truck/load quantities.

50 Through arrangements made by Dr Pepper, the bottlers finance their purchases with a Dallas, Texas bank. The company is contingently liable for repayment of these loans to the bank. Such loans aggregated approximately \$7,240,000 at December 31, 1979. In addition, Dr Pepper Company continued its aggressive vendor refurbishment program offering bottlers the opportunity to repaint and rework vendors already in the market. The program provides a fresh presentation of the Dr Pepper trademark.

Promotion/advertising

51 Dr Pepper's national promotion programs have received improved retail support throughout the country. The Be a Pepper theme has generated a record market share and continues to be a valuable property. More than 95 percent of 500 franchised bottlers supported Be a Pepper Month by promoting Dr Pepper-identified sportswear through grocery stores and utilizing the vast network of J. C. Penney retail stores to merchandise wearables and Dr Pepper in bottles, cans, and cups.

52 Also, each of 478 franchised markets is individually analyzed, and local marketing plans are adjusted to better fit Dr Pepper's current marketing situation. Important in this process is the empirical identification of the marketing needs Dr Pepper has demonstrated at various points of maturity along its growth curve. These analyses led to categorization of different programs by market and have improved the focus for the total program.

53 Two weeks before the 1980 board meeting, the marketing and advertising programs for 1981 were revealed to nearly 2,000 franchised Dr Pepper plant owners and managers attending the annual bottlers meeting in San Francisco.

54 New and better marketing and advertising programs give confidence that Dr Pepper and Sugar-Free Dr Pepper brands will be able to compete more effectively in the 1980s. Be a Pepper will continue to be the basis of advertising and promotion programs.

55 *AIM* is the action word for marketing and an acronym to analyze, innovate, and make it happen.

56 TV commercials again will feature Pied Pepper David Naughton (Exhibit 8). He is joined in one spot by Mickey Rooney, star of the Broadway hit musical, *Sugar Babies* (Exhibit 9). Radio talent includes Barbara Mandrell—Country Music Association Entertainer of the Year—for Sugar-Free

exhibit 8

exhibit 9

Dr Pepper. The Little River Band and the Statler Brothers vocalize radio commercials for brand Dr Pepper.

57 An expanded advertising budget will ensure millions more impressions for Dr Pepper and Sugar-Free Dr Pepper via network TV, radio, and print media. The latter includes new ad schedules in prestigious magazines such as *People, Cosmopolitan, Good Housekeeping, Woman's Day,* and *McCall's*.

58 On January 22, 1981 the following report appeared in *The Wall Street Journal:*

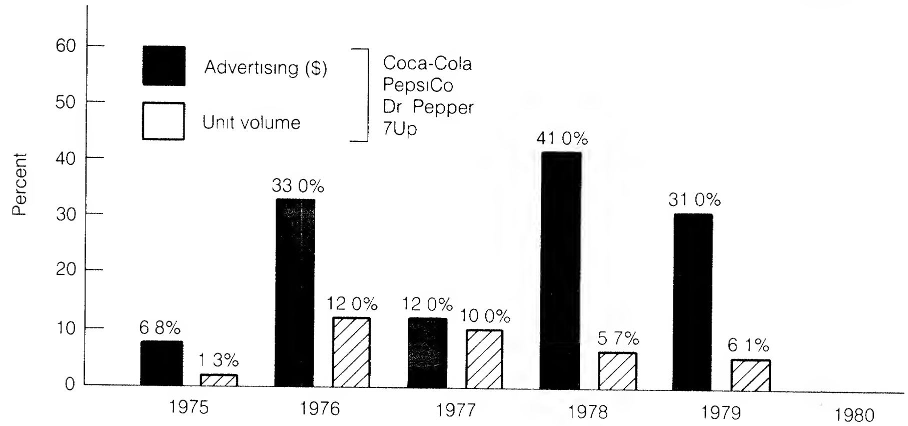
> Dr Pepper Co. filed suit in federal court against Sambo's restaurants, Inc., and Bozell & Jacobs Inc., an advertising agency, claiming that Sambo's "dancing seniors" commercial is an imitation of its popular "Be a Pepper" commercial.
>
> The suit says the Sambo's commercial, produced by Bozell & Jacobs, is "designed to attract senior citizens into Sambo's restaurants" and uses a jingle, "parts of which are substantially similar to the jingle composed" by Dr Pepper. The suit says the Sambo's commercial even contains the phrase, "don't you want to be a senior, too?" Dr Pepper's commercial uses the phrase "wouldn't you like to be a Pepper, too?"
>
> Moreover, the suit claims the format and theme of the Sambo's commercial, including the music and dancing, "are very similar" to Dr Pepper's commercial. The suit says the use of the commercial has hurt Dr Pepper because it attracts customers into Sambo's restaurants "more than one half of which don't serve Dr Pepper, but do serve soft drinks other than Dr Pepper."
>
> This lawsuit indicates the importance that the company attaches to its award-winning national advertising theme conceived by Young & Rubicam, Inc., back in 1970. With the 1970 advertising campaign, Dr Pepper became "America's Most Misunderstood Soft Drink." And in many parts of the country it was. Research showed that consumers though since it was brown it should taste like a cola or a root beer. Thus, the "Most Original Soft Drink Ever" campaign was developed and mini-musical TV commercials told consumers "It's not a cola, it's something much, much, more. . . .

59 Once the individuality of the product was established, advertising was directed to establish the individuality of Dr Pepper drinkers who became Peppers in 1978. The "Pepper-ization of America" has been one of the most successful campaigns ever with TV commercials featuring David Naughton placing among the top in viewer polls.

60 Today's consumers can hardly miss the soft-drink commercials that proliferate television, radio, billboards, and other advertising media. Behind all this advertising blitz, however, an ominous reality is hidden as can be seen from Exhibit 10.

exhibit 10

Advertising outlays outpacing gains in consumption (percent increase over prior years)



Source: Beverage industry; and Leading National Advertisers, Inc.

Trademarks

61 The importance of Dr Pepper's trademark (Dr Pepper) to its business cannot be overemphasized. Trademarks are valid as long as they are used properly for identification purposes. Federal registrations of trademarks are protected for 20 years and can be renewed indefinitely as long as the trademarks are in lawful use. Dr Pepper's federal registration for Dr Pepper is valid and subsisting in the U.S. Patent Office.

62 The Dr Pepper trademark has long been identified with the numerals 10, 2, and 4. People frequently ask what they mean.

63 A Columbia University professor, Dr. Walter H. Eddy, conducting research into the human diet, discovered that three meals per day were insufficient to provide energy to keep an active person at top-level efficiency. He pinpointed three in-between mealtimes during the day when energy in the human body drops to its lowest ebb. These are 10 A.M. and 2 and 4 P.M.

64 In a book titled *The Liquid Bite*, he urged that around these periods each day a normal person should restore energy through food consumed in liquid form, such as in a pure, healthful soft drink like Dr Pepper. The sugar content in Dr Pepper supplies quick energy. Thus, the numerals 10, 2, and 4 were identified on the clock-shaped Dr Pepper trademark pointing up these specific hours as a reminder that Dr Pepper is not only a delightfully different soft drink but also a "Friendly Pepper-Upper." (See Exhibit 11.)

65 Other than its federal license agreements, Dr Pepper has no material, existing trademark license agreements permitting the use of its trademark in advertising. Generally such agreements are nonexclusive, and the right to use a trademark terminates upon cancellation of the trademark license agreement.

exhibit 11
Dr Pepper's 10-2-4 trademark

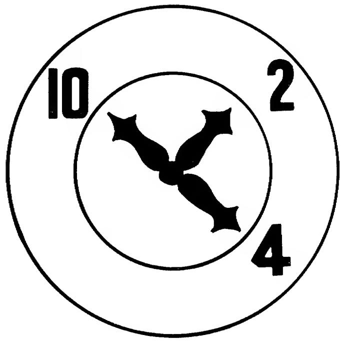
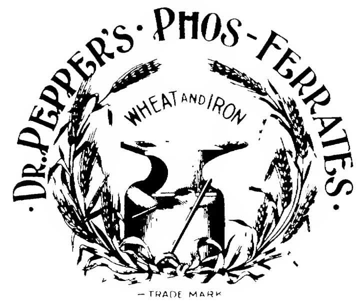


exhibit 12
The original Dr Pepper trademark (1885)



International operations

66 The foreign operations of the company currently include the Bahama Islands, Canada, Guam, Japan, Malta, Great Britain, Saudi Arabia, Puerto Rico, Guatemala, Honduras, Jordan, Kuwait, Dubai, West Samoa Island, Bahrain, Bermuda, and Northern Ireland.

67 In October 1980, the company announced that distribution of Dr Pepper was begun throughout Sweden and five states in Nigeria, West Africa.

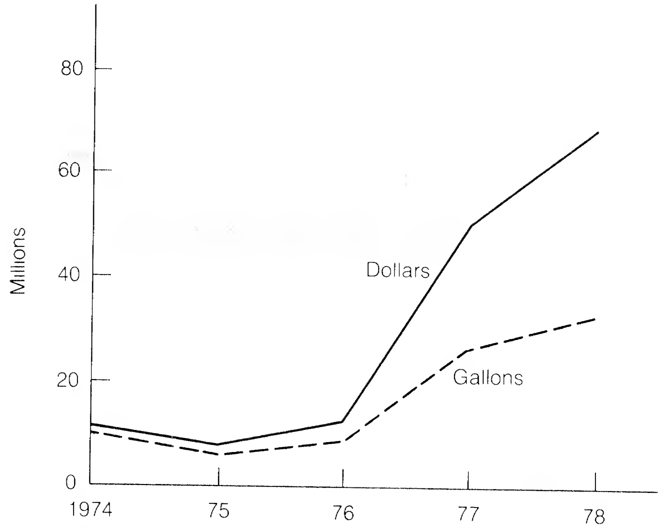
68 The ventures are the first for Dr Pepper in Africa and Scandinavia and the new franchisees report successful introductions with broad initial distribution registered in grocery and service trades.

69 In January 1981, Dr Pepper entered its first South American market with distribution in four markets in Chile. Dr Pepper is now sold in countries with a combined population of 287 million. This compares to countries with a population of 137,150,000 just five years ago. These international operations have an immaterial impact on total company business, accounting for 2 percent of total 1980 sales. However, the trend is definitely toward more international orientation (see Exhibit 13).

Regulations

70 Government decisions can have profound impact on Dr Pepper Company and consumers. To keep management, employees, and shareholders apprised of new and on-going government and scientific matters, Bill Massmann is Dr Pepper Company's principal communicator with legislators, regulatory agencies, trade associations, and scientific groups. His major involvement in 1980 was with franchise legislation (a major bill was passed), the Food and Drug Administration's unsuccessful attempt to ban saccharin, and USDA's partial ban on soft drinks in schools. Massmann described his job in the following statement.

exhibit 13
Quantity and value of soft-drink exports



Source: Bureau of Census.

The course of my job introduces new facets to old government issues and challenges of new problems. With firmly established products like Dr Pepper and Sugar-Free Dr Pepper, our company has a solid foundation for growth. Our growth objectives make everyone's job important. Because we are still a rather small and uncomplicated company, there is much sharing of information and ideas. This makes us able to react quickly to changing conditions; a definite advantage in future times of decision.

71 On March 9, 1977, the U.S. Food and Drug Administration (FDA) stated that it would issue a proposal to ban the use of saccharin in foods. The proposed ban was published on April 15, 1977, and could have taken effect as early as mid-July 1977. Subsequently, on November 23, 1977, the Saccharin Study and Labeling Act was signed into law. The act provided among other things, that the FDA could not ban the use of saccharin in foods for an 18-month period, ending May 23, 1979.

72 This moratorium on the proposed ban expired on May 23, 1979, but the U.S. House of Representatives overwhelmingly approved another moratorium which would expire on June 30, 1981.

73 In the summer of 1980, legislation was passed to extend a ban through June 1981, prohibiting any regulatory action by the Food and Drug Administration against saccharin, the only approved artificial, nonnutritive sweetener used in Sugar-Free Dr Pepper and all dietary soft drinks produced in the United States.

74 Dr Pepper is confident that saccharin is safe. It claims that there is no evidence that saccharin has ever caused cancer in humans. Scientific evi-

dence of the safety of saccharin continues to mount as a result of exhaustive testing by the government and private institutions. Studies by the National Cancer Institute, American Health Foundation, and Harvard University show no association between the risk of human bladder cancer and saccharin use.

75 On another front, a nine-year-long struggle with the Federal Trade Commission (FTC) to preserve the integrity of the bottler franchise system reached a positive conclusion for Dr Pepper. In July 1980, President Carter signed into law the Soft Drink Interbrand Competition Act, thus ending a battle that began in 1971 when an FTC complaint questioned the validity of the system of protected bottler franchises.

76 Almost all plants in the United States which bottle Dr Pepper and Sugar-Free Dr Pepper are subject to federal, state, or local laws or regulations regarding discharges into the environment. Compliance with these laws and regulations has not had, and is not expected to have, a material effect on the financial position or results of operations of the company.

77 A few states have adopted statutes intended to reduce solid waste in the form of discarded bottles, cans, and other packaging materials. These statutes generally require purchasers to make deposits on soft-drink bottles or cans, or they impose a tax on packaging material that is payable at the time the packaging material is sold by its manufacturer. The laws have tended to increase soft-drink prices in the states that adopted them, and depending upon the present degree of use by a particular bottler or nonreturnable containers, they may have an adverse impact on the sales and profits of bottlers there.

78 Another sensitive issue for the soft-drink industry, and Dr Pepper in particular, is a Food and Drug Administration warning to pregnant women to curb caffeine consumption. This warning stems from a study that was completed in 1980 and possibly linked caffeine with birth defects. The economic impact of such an issue is enormous because caffeine is an ingredient in widely consumed products, including soft drinks (see Exhibit 14).

exhibit 14
Caffeine count

Beverage	*Milligrams*
Coffee:	
1 cup	93–153
Tea:	
1 cup brewed 1 minute	28
1 cup brewed 3 minutes	44
Chocolate:	
1 oz.	5
Soft drinks:	
Coca-Cola, Pepsi, Dr Pepper, Mountain Dew, Mello Yello (12 oz. can)	32–65

Source: American Dietetic Association and Food and Drug Administration.

79 On yet another front, a 1979 Food and Drug Administration nationwide survey found that Americans want food labels to list all ingredients, tell more about calories, sugar, cholesterol and fat, and be written in simpler language. Current rules require disclosure of ingredient and nutritional information on only some foods. Dr Pepper has taken the initiative in voluntarily disclosing the nutritional information of their products as evidenced by Exhibit 15, part of the company's promotional material.

exhibit 15
Dr Pepper's nutritional information and ingredients (one serving (8 ounces/240 ml.)

	Dr Pepper	*Sugar-Free Dr Pepper*
Calories	96	2
Carbohydrates	24.8 grams	0.5 gram
Sodium*	18.4 mg	24.0 mg
Phosphorus*	26.4 mg	28.0 mg
Calcium*	6.4 mg	0
Potassium*	1.6 mg	0
Chlorides*	11.2 mg	9.6 mg
Saccharin	0	69.1 mg/0.29%
Caffeine	26.4 mg	26.4 mg

* The quantity of these elements may vary slightly due to variations in treated local water used to produce Dr Pepper.

Dr Pepper and Sugar-Free Dr Pepper contain no fat, protein, vitamins, or other minerals requiring disclosure by labeling regulations.

80 Other governmental rulings that may have an effect on Dr Pepper's operations are those concerning the evaluation—by consumer panels set up by the FTC—of media messages to detect misleading advertising; a protectionist national sugar policy; and finally, a proposed ban in schools on premeal soft drinks (a ban advocated by the USDA).

81 On this last issue, president Clements made the following statement during the 1978 annual stockholders' meeting:

> We are interested in the health of children. We do not sell our product as a health product. We feel very strongly that our product and similar products are extremely important parts of the diet of Americans, and particularly the youth. It provides a balanced diet. We don't suggest that they drink it instead of milk.
>
> We are working very hard to try to educate people because there is less education on nutrition than there is on economics. The American people are ignorant, virtually, of economics and even less informed on nutrition. We are working hard to try to point out the facts and to provide Dr Pepper as a variety part of the diet, not as a replacement of anything in particular.

Operations

82 The principal administrative and manufacturing facilities of the company are located in Dallas, Texas, in buildings of approximately 298,000 square feet

aggregate, situated on 27 acres of land. Additionally, the company has a manufacturing facility in Birmingham, Alabama, containing 31,000 square feet which is situated on less than one acre of land. The land and buildings at both locations are owned by the company. The buildings are in good condition and contain the equipment necessary for the production of concentrate and syrups to meet the needs of its customers.

83 In 1978, the Dr Pepper Metroplex Refreshment Company completed construction of its $21 million production and distribution facility in the Dallas suburb of Irving. The facility contains 440,000 square feet, of which 385,000 square feet is used for production and warehousing, 26,000 square feet for office area, and 29,000 square feet for maintenance and special events. It contains five high-speed bottling lines and one high-speed canning line. Production capability of the facility is 25 million cases annually.

84 The company's Metroplex bottling company occupies additional warehouse buildings. One, at the site of the Dallas manufacturing facility, has an area of 102,000 square feet. Two additional warehouses of approximately 33,000 square feet and 67,000 square feet, each situated on approximately four acres of land, are located in another area of Dallas and Fort Worth, Texas, respectively.

85 The San Antonio, Texas, bottling subsidiary owns 30,000 square feet of administrative-production-distribution facilities situated on four acres. In Waco, a 36,000-square-foot administrative-distribution facility located on four acres is owned by that subsidiary. Buildings and equipment owned by San Antonio and Waco are well maintained.

86 The company's Houston subsidiary performs a distribution function from two adjacent warehouses, 75,200 square feet and 72,500 square feet, respectively, both of which are occupied under short-term leases. A 21-acre site has been purchased in Houston for an administrative-production-distribution facility. The 200,000-square-foot plant planned for first quarter 1981 start-up has one high-speed dual filler bottling line and one high-speed 72-valve canning line. Estimated investment of the Houston facility project is $18 million, and is to be financed principally through internally generated funds.

87 The company has a bottling and canning facility located in Gardena, California on approximately nine acres of land. This property houses its administrative, manufacturing, and warehousing operations within several buildings which total 135,700 square feet. This subsidiary has distribution warehouse operations located on approximately 2½- and 5-acre tracts in Fullerton and Sylmar, California, respectively. Total floor space of the buildings at each location is 33,000 square feet and 25,000 square feet, respectively. The property and equipment, which are owned by the subsidiary, are in good condition. The company's bottling subsidiaries lease various warehouses for distribution purposes.

88 The company has in escrow a parcel of land located in Riverside, Califor-

nia, which consists of 18 acres of undeveloped land. Closing date is scheduled for April 1980. This property is planned as a site for future location of Southern California Packaging Company.

89 The company owns a 77-acre tract of undeveloped land in Dallas, Texas. This land was purchased in 1974 for the purpose of building a production and distribution facility to serve the entire Dallas/Fort Worth Metroplex. Further studies indicated, however, that changing trends in product distribution, as well as a shift in location of high-volume retail accounts, made a 45-acre site in Irving, Texas a more advantageous location. The Irving property was purchased in December 1976. Dr Pepper plans to sell the 77-acre tract.

90 The company's bottling capability was enlarged on August 1, 1980, when the newly formed Dr Pepper Bottling Company of Corpus Christi, a wholly owned subsidiary of Dr Pepper Company, purchased the corporate stock of the Dr Pepper/Royal Crown Bottling Company of Corpus Christi, Texas.

91 The Corpus Christi manufacturing plant becomes the sixth wholly owned bottling subsidiary of Dr Pepper Company and will operate as the Dr Pepper Bottling Company of Corpus Christi. This acquisition will strengthen the position of Dr Pepper and Sugar-Free Dr Pepper in this growing south Texas market. Since 1975, Dr Pepper has enjoyed a 60 percent increase in sales in the Corpus Christi market. (See Exhibits 16 and 17.)

exhibit 16

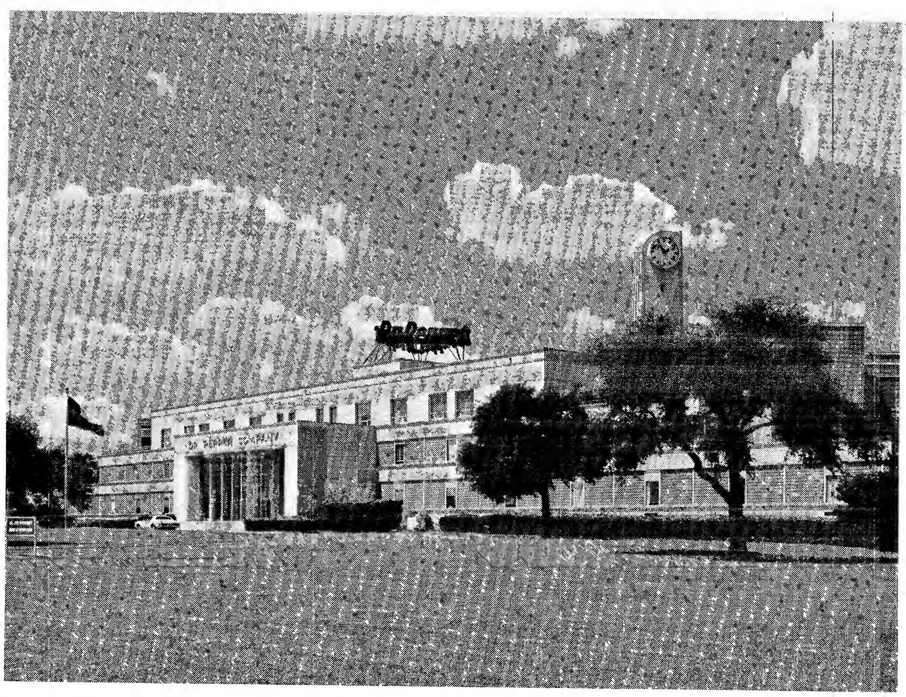


exhibit 17
Parent and subsidiaries

Name	Location	State of incorporation
Parent:		
Dr Pepper Company	Dallas, Texas	Colorado
Subsidiaries:		
Dr Pepper Metroplex Refreshment Company*	Dallas, Texas	Texas
Dr Pepper Bottling Company of Waco*	Waco, Texas	Colorado
San Antonio Dr Pepper Bottling Company*	San Antonio, Texas	Colorado
Dr Pepper International Sales Corp.*	Dallas, Texas	Texas
Dr Pepper Bottling Company of Southern California*	Gardena, California	California
Dr Pepper Bottling Company of Houston, Inc.*	Houston, Texas	Texas
National Drinks Bottling Company†	Gardena, California	California
National Drinks Leasing Company†	Gardena, California	California
Dr Pepper Japan Company*	Tokyo, Japan	Texas
Dr Pepper Beverage Sales Company*	Dallas, Texas	Texas
Southern California Packaging Company*	Gardena, California	Texas
Dr Pepper Bottling Company of Corpus Christi, Inc.*	Corpus Christi, Texas	Texas

* Wholly owned.
† Wholly owned by Dr Pepper Bottling Company of Southern California.

Production

92 Dr Pepper Company has manufactured high-quality syrups and concentrates since 1885. Few companies in any food category have manufactured longer. The most unique taste in the soft-drink industry begins in the company's compounding lab and syrup-making facility in Dallas where fountain syrups and concentrates are made. After compounding, formula ingredients are blended to rigid specifications by syrup makers under conditions designed to assure a uniform and wholesome product.

93 There are 23 flavors and other ingredients that produce the inimitable taste of Dr Pepper. The formula is locked in two banks with access restricted to a handful of company officials, two at a time. In addition to the ingredients, the flavor depends on a complicated blending process that produces the aromatic Dr Pepper concentrate. The necessity of secrecy was recently stressed by Dr Pepper Company chairman, W. W. Clements: "Our greatest strength is the very unique and distinctive taste of Dr Pepper. After 95 years in the marketplace, it still has not been successfully copied or imitated."

94 Soft-drink companies have expressed differing opinions on the quality and taste of high fructose corn syrup (HFCS), a less expensive sweetner than the traditional sucrose. Because of such diverse views on the implementation of fructose as a total replacement of sucrose, major franchisors are using various amounts of HCFS in their sweetener formulations—and some use none at all.

95 Extensive consumer testing of high fructose corn sweetener (HCFS 55 grade) led Dr Pepper to authorize bottlers to use the substance on a 100 percent sweetener basis in Dr Pepper. This provides substantial cost savings versus sugar (sucrose) or blend usage and makes Dr Pepper a more profitable product, thus encouraging sales. Similar tests are now being conducted on an even more efficient fructose grade (HCFS 42) with good initial results.

96 In 1979, cost of sales increased 7.8 percent. This increase is in line with the increase in net sales and accounts for the fact that gross profit as a percent of net sales for both 1979 and 1978 was 47.9 percent. The ingredients and materials component of this cost category was up 9.3 percent in 1979 and reflects the impact of increased cost of sweeteners (both sugar and HCFS prices were up approximately 9 percent and 12 percent, respectively, for the year), returnable glass (increases approximated 12 percent), cans (up 9 percent), and paper products (corrugated cartons increased 20 percent during the year). As a percentage of net sales, cost of sales was 52.1 percent for both 1979 and 1978.

97 In 1978, cost of sales increased by 17.7 percent over 1977. In 1980, like 1978 and 1979, Dr Pepper experienced significant increases in the prices of raw materials and packaging supplies (see Exhibits 18 and 19).

Packaging

98 Packaging has played an important role in expanding the availability of soft drinks. Cans are lightweight, do not break, help retain coolness, are especially adaptable for vending machines, and offer convenience for single servings. Bottles offer flexibility because of the range of sizes and are resealable and refillable (Exhibit 20). The plastic bottle overcomes the glass bottle's disadvantages of breakableness and weight.

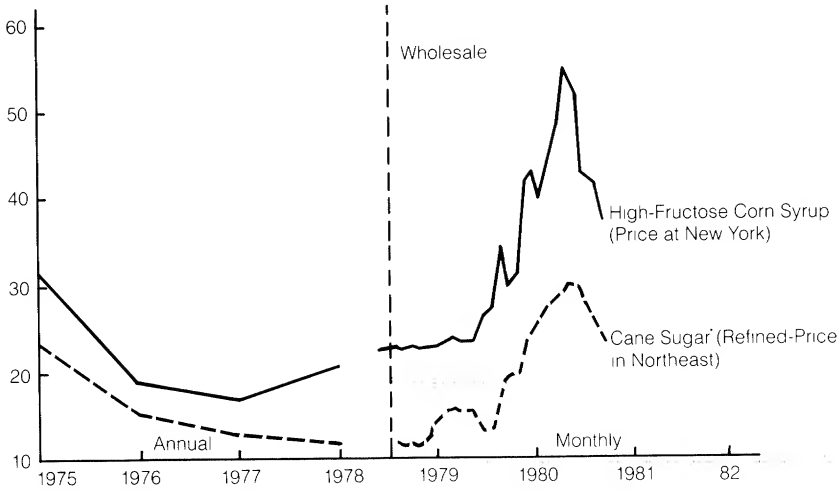
99 Coca-Cola took an early lead in plastic bottle development with the acrylonitrile (AN) bottle produced by Monsanto until the FDA raised questions as to its safety. The agency contends that acrylonitrile monomers can

exhibit 18
Producer price indexes

Year	*December 1968–100 Kola syrup*	*1967–100* Granulated cane sugar	Corn syrup	Non-alcoholic beverages	Beverage bottle, returnable	*December 1972–100 Aluminum soft-drink can, 12 oz.*
1980*	166.7	409.4	246.6	258.9	287.5	199.7
1979	147.4	231.1	170.0	227.1	245.4	188.1
1978	139.1	206.2	144.2	211.6	231.9	169.8
1977	133.9	170.9	—	198.1	216.2	154.1
1976	131.4	192.1	—	187.2	197.8	142.2
1975	139.4	314.8	—	186.1	178.3	137.4

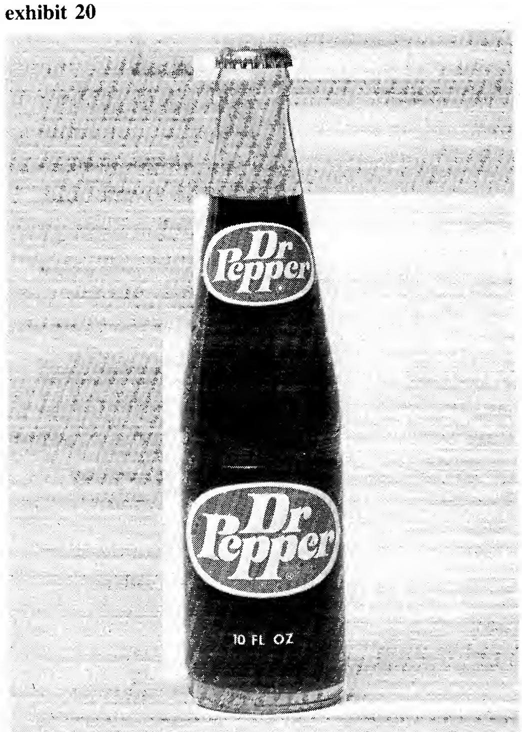
* Preliminary.
Source: Bureau of Labor Statistics.

exhibit 19
Sugar and corn syrup prices (cents per pound, dry basis)



Source: Department of Agriculture.

exhibit 20



migrate from the bottle to the beverage. Monsanto maintains that no migration occurs under normal conditions of use. Coca-Cola has discontinued use of the bottle until the matter is resolved.

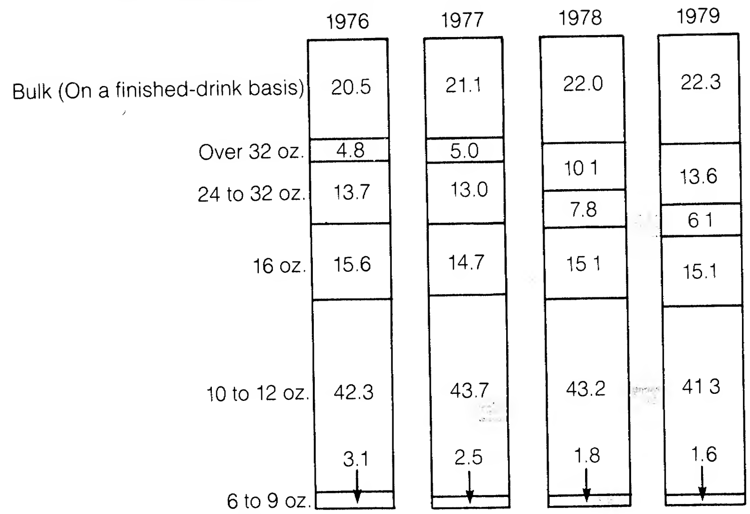
100 About the time the safety question was raised for the AN bottle, PepsiCo announced the introduction of plastic bottles made from polyethylene terephthalate (PET) and manufactured by Amoco Chemical. The PET bottle is also produced by Goodyear Chemical, Hoover Ball & Bearing, and Owens-Illinois.

101 Sales of plastic beverage bottles, in their infancy in 1977, jumped to about 800 million units in 1978, and doubled in 1979, dominating the large-size, two-liter soft-drink market. In 1979, plastic began to penetrate the one-liter size market, even though that size in plastic costs 22 percent more than glass. The glass industry fought back, and introduced in 1979 the so-called contour-pack: a six-pack of short glass bottles held together by a plastic lid. The plastic industry's response in 1981 was a half-liter size (16.9 oz.) made out of the same polyethylene terephthalate (PET) as the successful two-liter bottle. The new machines that produce these bottles can produce them at a cost competitive to the 16-oz., nonreturnable glass bottles, which cost about 8.5 cents. To make things even more complicated, a new technology of continuous casting of aluminum sheets has made aluminum cans, which in 1980 cost about 9 cents, much less costly to produce. *Beverage Industry* predicted that plastic bottle containers will account for 27.5 percent of all soft-drink containers in 1985. In 1980, that percentage was 17.3 percent. Essentially, Dr Pepper's product line includes the size shown in Exhibit 21. In addition to the regular six-pack bottles or cans, Dr Pepper introduced in 1979 a 12-pack can carton that appears to be an outstanding success. The industry's bulk and package sales are portrayed in Exhibit 22. Bulk sales (including over 32 oz. containers) are the most rapidly expanding package segments.

exhibit 21
Packaging

Product	*Returnable Glass Bottles*	*Nonreturnable Glass Bottles*	*Cans*
Dr Pepper and Sugar-Free Dr Pepper	6 ounces	10 ounces	8 ounces
	10 ounces	16 ounces	12 ounces
	12 ounces	32 ounces	16 ounces
	16 ounces	1 liter	
	26 ounces	48 ounces	
	28 ounces	64 ounces	
	32 ounces	2 liters	
	1 liter		
	2 liters		
Salute (six flavors)	10 ounces	10 ounces	12 ounces
	16 ounces		
Waco (fountain syrup in six flavors)			

exhibit 22
U.S. bulk and package sales of soft drinks (in percent)



Source: National Soft Drink Association.

Managerial incentive programs

102 In recent years, Dr Pepper has had two plans that were created to motivate effective managerial performance: (1) qualified stock option plan, and (2) long-term incentive compensation plan.

103 The qualified stock option plan under which the board of directors may grant options to selected employees to purchase common stock expired in 1979.[1] At December 31, 1980, no options were outstanding to purchase shares (200 shares in 1979). During 1980, options were exercised for 200 shares at $10.75 per share ($2,150 aggregate). During 1979, no options were exercised and 39,750 shares were forfeited At December 31, 1980, there were no unoptioned shares available for option.

104 In 1976, Dr Pepper Company shareholders approved the adoption of a long-term incentive compensation plan which includes a long-term nonqualified stock option plan and a contingent performance award plan for key managerial personnel. On April 15, 1980, the company established a cash incentive plan. The plans are administered by a committee of the board of directors whose members are neither officers, employees, nor participants under the plan.

105 Nonqualified stock options and/or performance awards can be granted each year beginning in 1976 and continuing through 1985. Cash incentive awards may be granted through 1990. A total of 500,000 shares of Dr Pepper

[1] A qualified pension plan is one that meets stringent IRS and ERISA regulations and provides tax advantages to both the company and employees. An unqualified plan does not acquire the same tax advantages, but as a result, is not subject to certain IRS restrictions.

common stock is available for nonqualified stock options or performance awards. The exercise price of options granted under the plan may not be less than the quoted market price at date of grant, and the options expire 10 years from the date of grant or at an earlier date if specified.

106 Contingent performance awards are to be earned over a five-year award period and the cash portion is payable at the end of that period. A new five-year award period will begin each year through 1985. The cash incentive awards are available to be earned each year through 1985. The cash incentive awards are available to be earned over a three-year award period and are payable at the end of that period. The cash portion of performance awards and the cash incentive awards, which are being accrued over the award periods, may be adjusted based upon corporate performance goals attained for such periods. Maximum cash performance awards available at December 31, 1980 and 1979 were $1,834,000 and $1,649,000, respectively. In anticipation of the company's attaining part of the performance goals, $201,000 of the cash awards are currently accrued. The portion of performance awards granted in the form of nonqualified stock options is not exercisable until three years after the date of grant for options granted in 1980 and five years for options granted in prior years.

107 Nonqualified stock options granted are detailed as follows:

Nonqualified stock options

Performance award year	*Number of shares*	*Option price*	
		Per share	*Aggregate*
1978 and prior	35,845	$12.125–15.625	$ 509,000
1979	12,598	15.375	194,000
1980	29,573	11.125	329,000
	78,016		$1,032,000

In addition to the above, nonqualified stock options to purchase shares of Dr Pepper common stock are outstanding as follows:

Year	*Number of shares*	*Option price*	
		Per share	*Aggregate*
1978 and prior	84,299	$12.125–15.625	$1,196,000
1979	33,404	15.375	514,000
1980	67,447	11.125	750,000
	185,150		$2,460,000

108 During 1980, options were exercised for 1,059 shares at $12.125 per share ($12,840 aggregate) and 26,703 options were forfeited. At December 31, 1980, the stock options granted in 1979 and prior years were exercisable. The nonqualified stock options granted in 1980 will become exercisable on April 15, 1981.

Finance and accounting

109 Dr Pepper has experienced a steady increase in annual sales since 1976. Exhibit 23 provides a five-year summary of operations. While its gross margin has remained relatively stable, operating expenses have steadily increased relative to sales. Exhibit 24 summarizes Dr Pepper's balance sheet over the last four years. Exhibit 25 summarizes the changes in Dr Pepper's financial position over these four years.

110 In the fourth quarter of 1980, the company changed its inventory valuation basis to the last-in, first-out (LIFO) methods for virtually all inventories not previously on LIFO. In previous years, these inventories were stated at the lower of cost (first-in, first-out) or market (net realizable value). Had the FIFO method been used in 1980, inventories would have been approximately $1,280,000 higher than as reported at December 31, 1980. The effect of the change in 1980 was to reduce net earnings by approximately $691,000 (4 cents per share). The excess of current cost over stated last-in, first-out cost was approximately $2,070,000 at December 31, 1980 and was not material in 1979 and prior years.

111 Dr Pepper and its subsidiaries provide for depreciation of property, plant, and equipment on a straight-line basis over the estimated useful life of the asset.

112 Maintenance and repairs are charged to operations as incurred; renewals and betterments are capitalized and depreciated. The cost and accumulated depreciation of properties sold or disposed of are removed from the accounts. The resultant profit or loss on such transactions is credited or charged to earnings.

113 The excess costs over net assets of acquired businesses and costs of franchises acquired subsequent to 1971 are being amortized primarily over 40 years. The excess costs over net assets of acquired business and costs of franchises acquired in 1971 and prior years are not required to be amortized. Deferred taxes are provided for all items includes in the consolidated statements of earnings (Exhibit 23) regardless of when such items are reported for tax purposes.

114 Investment tax credits are recorded as a reduction of federal income tax expense in the year realized. The expected provision for income taxes, computed by applying the federal income tax rate of 46 percent in 1980 and 1979 and 48 percent in 1978 to earnings before income taxes, is reconciled to the provision for income taxes as follows:

	1980	*1979*	*1978*
Computed expected tax provision	$22,827,000	$19,923,000	$20,357,000
Investment tax credit	(881,000)	(867,000)	(1,593,000)
Other	1,134,000	646,000	81,000
Total	$23,080,000	$19,702,000	$18,845,000

exhibit 23

DR PEPPER COMPANY
Five-Year Summary of Operations
($000 except as noted and for per share amounts)

	1980	1979	1978	1977	1976
Operating results:					
Net sales	$333,165	$291,762	$271,008	$226,750	$187,216
Cost of sales	170,842	152,033	141,093	119,910	95,642
Gross profit	162,323	139,729	129,915	106,840	91,574
As a % of net sales	48.7%	47.9%	47.9%	47.1%	48.9%
Administrative marketing, and general expenses	114,753	97,821	88,969	69,665	59,711
Operating profit	47,570	41,908	40,946	37,175	31,863
Other income, net	2,053	1,403	1,464	1,329	1,563
Earnings from continuing operations before income taxes	49,623	43,311	42,410	38,504	33,426
As a % of net sales	14.9%	14.8%	15.6%	17.0%	17.9%
Income taxes	23,080	19,702	18,845	18,182	15,834
Effective tax rate	46.5%	45.5%	44.4%	47.2%	47.4%
Earnings from continuing operations	26,543	23,609	23,565	20,322	17,592
Earnings from discontinued operations, net of taxes	—	—	—	—	193
Net earnings	26,543	23,609	23,565	20,322	17,785
As a % of net sales	8.0%	8.1%	8.7%	9.0%	9.5%
Balance sheet data:					
Current assets	$ 59,826	$ 55,942	$ 47,892	$ 50,032	$ 59,361
Current liabilities	29,987	20,834	16,353	16,614	22,536
Working capital	29,839	35,108	31,539	33,418	36,825
Property, plant, and equipment, net	72,950	57,180	49,479	35,481	21,839
Additions to property, plant, and equipment	24,757	15,840	20,604	18,093	6,644
Other assets	14,880	11,108	10,763	10,819	12,164
Total assets	147,656	124,230	108,134	96,332	93,364
Capitalization:					
Notes payable (including short-term portion)	8,993	949	539	856	10,902
Deferred taxes and credits	5,661	4,757	3,572	2,480	1,186
Stockholders' equity	109,928	97,914	87,839	76,587	66,333
Total invested capital	124,582	103,620	91,950	79,923	78,421
Per share of common stock data:					
Earnings from continuing operations	$ 1.31	$ 1.17	$ 1.17	$ 1.01	$ .87
Earnings from discontinued operations	—	—	—	—	.01
Net earnings	1.31	1.17	1.17	1.01	.88
Dividends	.72	.67	.61	.53	.40
Book value	5.44	4.85	4.35	3.79	3.31
Number of shares outstanding	20,202	20,200	20,200	20,200	20,020
Number of employees	2,300	2,100	2,100	1,800	1,700

exhibit 24

DR PEPPER COMPANY AND SUBSIDIARIES
Consolidated Balance Sheets
For the Years 1977–1980

Assets	*1980*	*1979*	*1978*	*1977*
Current assets:				
Cash and temporary cash investments	$ 13,333,000	$ 12,932,000	$ 7,822,000	$15,421,000
Receivables:				
Trade accounts (net of allowance for doubtful receivables of $447,000 in 1980, $343,000 in 1979, $348,000 in 1978, and $308,000 in 1977)	25,149,000	21,072,000	19,443,000	14,425,000
Other notes and accounts	459,000	380,000	251,000	403,000
Inventories:				
Finished products	5,774,000	4,795,000	5,637,000	4,249,000
Raw materials and supplies	7,429,000	9,330,000	6,236,000	9,163,000
Prepaid expenses	7,682,000	7,433,000	4,301,000	2,466,000
Total current assets	59,826,000	55,942,000	43,090,000	46,127,000
Notes receivable and other investments	1,635,000	1,699,000	2,473,000	1,594,000
Land held for investment, at cost	1,787,000	1,787,000	1,787,000	1,787,000
Property, plant, and equipment—at cost:				
Land	5,747,000	4,594,000	2,488,000	2,292,000
Buildings and improvements	35,398,000	24,386,000	21,727,000	15,750,000
Machinery, equipment, and furniture	65,927,000	55,820,000	52,903,000	39,606,000
Total property, plant, and equipment	107,072,000	84,800,000	77,118,000	57,648,000
Less accumulated depreciation	34,122,000	27,620,000	22,837,000	18,262,000
Net property, plant, and equipment	72,950,000	57,180,000	54,281,000	39,386,000
Other assets—at unamortized cost or nominal value:				
Excess cost over net assets of businesses acquired	11,121,000	7,206,000	—	—
Franchises, formulae, trademarks, and other	337,000	416,000	6,503,000	7,438,000
Total other assets	11,458,000	7,622,000	—	—
Total assets	$147,656,000	$124,230,000	$108,134,000	$96,332,000
Liabilities and Stockholders' Equity				
Accounts payable and accrued expenses	$ 18,283,000	$ 19,742,000	$ 15,417,000	$13,289,000
Current portion of notes payable	405,000	224,000	169,000	205,000
Notes payable	6,508,000	—	—	—
Federal and state income taxes	4,791,000	868,000	767,000	3,120,000
Total current liabilities	29,987,000	20,834,000	16,353,000	16,614,000
Long-term notes payable, excluding current portion	2,080,000	725,000	370,000	651,000
Deferred federal income taxes	5,394,000	4,537,000	2,806,000	2,013,000
Other deferred credits	267,000	220,000	766,000	467,000
Stockholders' equity				
Common stock without par value. Authorized 50 million shares; issued 20,201,517 shares in 1980 and 20,200,258 shares in 1979, 20,200,313 shares in 1978, and 20,199,513 shares in 1977	13,133,000	13,117,000	13,117,000	13,108,000
Retained earnings	96,795,000	84,797,000	74,722,000	63,479,000
Total stockholders' equity	109,928,000	97,914,000	87,839,000	76,587,000
Total liabilities and stockholders' equity	$147,656,000	$124,230,000	$108,134,000	$96,332,000

exhibit 25

DR PEPPER COMPANY AND SUBSIDIARIES
Consolidated Statements of Changes in Financial Position
Years Ended December 31, 1977–1979

	1980	*1979*	*1978*	*1977*
Sources of working capital:				
Net earnings	$26,543,000	$23,609,000	$23,565,000	$20,322,000
Add items which do not affect working capital:				
Depreciation of property, plant, and equipment	8,987,000	8,141,000	6,603,000	4,523,000
Amortization of franchises, formulae, trademarks, and other	269,000	207,000	111,000	97,000
Deferred income taxes	857,000	1,531,000	793,000	827,000
Working capital provided by operations	36,656,000	33,488,000	31,072,000	25,769,000
Issuance of common stock (1,259 shares in 1980, 800 shares in 1978, and 179,091 shares in 1977)	16,000	—	9,000	518,000
Decrease in notes receivable and other investments	543,000	774,000	—	1,348,000
Decrease in franchises, formulae, trademarks, and other	—	—	824,000	—
Increase in long-term notes payable	1,924,000	355,000	—	344,000
Increase in other deferred credits	47,000	—	299,000	191,000
Total sources of working capital	$39,186,000	$34,617,000	$32,204,000	$28,170,000
Uses of working capital:				
Dividends on common stock	$14,545,000	$13,534,000	$12,322,000	$10,586,000
Additions to property, plant, and equipment	24,757,000	15,840,000	20,604,000	18,275,000
Increase in notes receivable and other investments	479,000	—	879,000	—
Retirement of long-term notes payable	569,000	—	281,000	2,726,000
Increase in franchises, formulae, and trademarks	—	—	—	100,000
Increase in other assets	4,105,000	1,326,000	—	—
Decrease in other deferred credits	—	346,000	—	—
Total uses of working capital	44,455,000	31,046,000	34,086,000	31,687,000
Increase (decrease) in working capital	$(5,269,000)	$ 3,571,000	$(1,882,000)	$(3,517,000)
Changes in components of working capital:				
Increase (decrease) in current assets:				
Cash and marketable securities	$ 401,000	$ 5,710,000	$(8,199,000)	$(19,951,000)
Receivables	4,156,000	1,758,000	4,866,000	2,843,000
Inventories	(922,000)	(1,342,000)	(1,535,000)	7,417,000
Prepaid expenses	249,000	1,926,000	2,725,000	252,000
Total increase in current assets	3,884,000	8,052,000	(2,143,000)	(9,439,000)
Increase (decrease) in current liabilities:				
Accounts payable and accrued expenses	(1,459,000)	4,325,000	2,128,000	2,800,000
Notes payable	6,689,000	55,000	(36,000)	(7,664,000)
Federal and state income taxes	3,923,000	101,000	(2,353,000)	(1,058,000)
Total increase in current liabilities	9,153,000	4,481,000	(261,000)	(5,922,000)
Increase (decrease) in working capital	$(5,269,000)	$ 3,571,000	$(1,882,000)	$ (3,517,000)

115 The weighted average amount of short-term debt outstanding during 1980 was $3,285,000 with a related weighted average interest rate of 9.4 percent. The maximum amount of short-term debt outstanding at any month-end during 1980 was $6,508,000.

116 Long-term notes payable are secured principally by property, plant, and equipment and bear interest at fixed rates ranging from 6 to 16 percent. The aggregate maturities of long-term notes payable for the five years ending December 31, 1985, are as follows: 1981—$405,000; 1982—$375,000; 1983—$315,000; 1984—$164,000; and 1985—$150,000.

117 During 1980, the company obtained a $55 million line of credit from several banks. In January 1981 the line was increased to $110 million. The line of credit agreements provide for a commitment fee of one half of 1 percent on the unused portion of the line.

118 The company's stock is listed on both the New York Stock Exchange and the Pacific Stock Exchange. Exhibit 26 shows the reported high and low prices on the New York Stock Exchange for the periods indicated. The closing price of the stock on December 31, 1980, was $11¼. In 1979 and 1978, the year-end closing prices were $11⅞ and $14½, respectively.

exhibit 26
Dr Pepper stock prices

	1980	*1979*	*1978*	*1977*	*1976*
High	$15⅞	$19¼	$20¼	$17¼	$17¾
Low	9½	19	13¼	11	11

Epilogue

119 An anthology of questions and answers during the 1980 annual meeting of Dr Pepper shareholders illustrates graphically the optimism with which the company's management envisions the future.

Shareholder: I understand that in New York City, Dr Pepper is marketed by Coca-Cola. I understand the advantages of that, but doesn't it create a divided loyalty? Wouldn't Coke rather sell Coca-Cola than Dr Pepper?

Clements: I think your question is a good one. Our bottlers in the room could answer that better than I, but as Hughes said, the secret in this business is volume. The only reason that bottlers today have more than one national brand is to get the volume. In recent years, bottlers could not grow fast enough to keep up with inflation and increased costs and support automated equipment. So, about 15 years ago, many bottlers started acquiring other national brands. Their loyalty is to *their* company to their bottom line and to their profits and it is a question of our building the right kind of marketing program for them. So, the question of divided loyalty is rather moot.

I might say that most bottlers in this country are independently owned and franchised and their only relationship with Coca-Cola or Pepsi or 7up or Dr Pepper Company is a franchise relationship. We have approximately 200 bottlers that

are Coca-Cola, about 180 that are Pepsi, and well over 200 that also have 7up. Many have RC and it is just a rare thing today to find one with just one product. I don't know of one at the moment.

Shareholder: Hughes mentioned the Metroplex plant operating at 80 percent efficiency. Could this be equated with capacity?

Clements: It is equated with the manufacturer's rated capacity of equipment and while that is not as high as we would like it to be, that is considered to be pretty good, isn't it? I see bottlers nodding their heads.

Shareholder: Can you tell us in which direction or which category you intend to diversify?

Clements: Our objective, first, is to broaden our base in the soft-drink industry. Once that is accomplished, we will try to find some related industry in which we have some knowledge and expertise we can use to build and broaden our base to allow us to be more competitive. So, it would probably be in some related food business.

Shareholder: Since the last annual meeting, has the company received any takeover or merger offers that have been unreported to the shareholders?

Clements: We have never received, since the last meeting or before, any offers—none—during the past year or before, since I have been here. The talk is rumor.

Shareholder: On the saccharin problem, are you doing anything to find a substitute for saccharin?

Clements: Yes, we have all been doing everything we can. There is no substitute on the horizon. None that has been developed, tested, or approved. There are some, like Aspartame, which has not proved to be successful for soft drinks and has not been approved for them. We do have, if forced, a low-calorie drink that would be on the market immediately after a ban on saccharin.

Shareholder (bottler): What effect will the defeat of the proposal for authorization of preferred stock have on diversification?

Clements: That's a good question. I am glad you asked because we had no plans to use preferred stock but our investment bankers and directors—all of us felt that in order to be fully equipped to make the best acquisition in the most favorable terms for the stockholders, we should have available common stock and preferred stock. Of course, we can always use credit. But it won't have any effect on our immediate plans.

Shareholder: I am a small shareholder. What will that 25 to 50 million share stock increase be used for? To give to the shareholders or will it be used for acquisitions?

Clements: Our plan is to use it for acquisitions. We have no plans for shareholder splits or anything. Of course, if we do, we would have to come back to the shareholders for that.

Shareholder: Just curious about marketing. Avery was talking about appealing to the 13–30 age group. A lot of us here are over 30. I am wondering if we are missing some of the market with those above 30. I understand a recent report appeared in *The Wall Street Journal* concerning the fact that more adults are freer with their money because of inflation, et cetera. We might want to consider that.

Clements: The purpose of our marketing strategy—age 13-30—is to reach them during their formative years when they are building taste habits. Now, we don't neglect, through our advertising and marketing, the older group. As a matter of fact, Sugar-Free Dr Pepper has been the greatest asset we have ever had in appealing to those older than 30. The reason is, even though demographics show the age brackets eschewing to an older one, we don't become 35 without going through the 13 to 30 age. So, we try to reach them there.

Shareholder: Why can't Dr Pepper deliver to smaller outlets. Coke can and I think you are missing a lot in the market by doing that. A lot of my friends, where I work, would all like to have a Dr Pepper.

Clements: We built our business on the smaller outlets and if we are not doing that, there is a breakdown in the service system of our sales organization.

All the top six companies, except Dr Pepper, are owned by large corporations and four of the five are multinational and multibillion dollar companies. They know the business. They have more sales dollars, more profits, and more resources than Dr Pepper. But we have one thing they don't and that is Dr Pepper. Believe you me, this is a tremendous advantage. Your company possesses the greatest advantage in our unique and distinctive product, Dr Pepper, and we expect to capitalize on it.

We have a consistent growth record which has enabled us to have an adequate base to build even more aggressively and successfully in the future. Again, I emphasize the uniqueness of Dr Pepper is your company's greatest strength for the future. We have an ever-growing number of imitators which only strengthens our position.

We face the future with confidence and hope you share our faith and enthusiasm. We appreciate your being here and even more, we appreciate your loyalty and continued support.

case 22

Marion Laboratories, Inc.

1 Michael E. Herman, senior vice president of finance for Marion Laboratories, had just received word that the board of directors was planning to meet in three days to review the company's portfolio of subsidiary investments. In particular, he and his senior financial analyst, Carl R. Mitchell, were to prepare an in-depth analysis of several of the subsidiaries so the board could be better positioned with respect to a subsidiary's compatability with Marion's overall strategic objectives. The analysis was part of a continuing process of self-assessment to assure future growth for the company. At the upcoming meeting the board was interested in a review of Kalo Laboratories, Inc., a subsidiary that manufactured specialty agricultural chemicals.[1]

2 Kalo was profitable and in sound financial shape for the fiscal year just ended. (See Exhibit 1.) But Kalo, in the agricultural chemical industry, was unique for Marion and Herman knew that Kalo's long-term status as a Marion Subsidiary would depend on more than just profitability.

3 Marion's future had been the subject of careful study following the first two years of earnings decline in the company's history. In fiscal 1975 net earnings for the company were 12 percent lower than in 1974. In fiscal 1976 Marion faced a more serious problem as earnings fell 30 percent below 1974 levels while sales decreased 4 percent and cost of goods sold rose by 12 percent above 1974 levels.

4 As a result of the interruption in the earnings' growth pattern, Marion has sought to reexamine its corporate portfolio of investments. By fiscal year 1977 some results from the reappraisal were seen as earnings rose 28 percent from the previous year. Although sales continued to climb, earnings had not yet recovered to the 1974 level by the end of fiscal year 1978. Marion's long-range planning was an attempt to define what the company was to become in the next 10-year period. Current analysis of subsidiaries and investments were analyzed within this 10-year framework. As part of this long-range planning, a statement of Marion's corporate mission was developed.

This case was prepared by Marilyn L. Taylor and Kenneth Beck of the University of Kansas. Reprinted with permission of the Case Research Association.

[1] Kalo Laboratories, Inc., was utilized as the case subject due to the singular nature of the segment information available in Marion Laboratories, Inc., SEC submissions, and does not reflect Marion's intentions as to its investment in Kalo or any of its other subsidiary operations. Materials in this case were generally gathered from publically available information.

exhibit 1

MARION LABORATORIES INC.
Sales Profits and Identifiable Assets by Industry Segments
For the Years Ended June 30, 1974–1978
($000)

	1978	*1977*	*1976*	*1975*	*1974*
Sales to unaffiliated customers:					
Pharmaceutical and hospital products	$ 84,223	$ 72,299	$59,236	$64,613	$54,165
Specialty agricultural chemical products	9,302	5,227	2,880	4,522	4,044
Other health care segments	23,853	22,605	18,722	14,961	13,569
Consolidated net sales	$117,378	$100,131	$80,838	$84,096	$71,778
Operating profit:					
Pharmaceutical and hospital products	$ 27,900	$ 23,439	$18,941	$28,951	$25,089
Specialty agricultural chemical products	905	382	(328)	881	620
Other health care segments	929	1,251	(593)	686	871
Operating profit	29,734	25,072	18,020	30,518	26,580
Interest expense	(1,546)	(1,542)	(898)	(97)	(83)
Corporate expenses	(5,670)	(4,474)	(3,106)	(2,795)	(2,475)
Earnings before income taxes	$ 22,518	$ 19,056	$14,016	$27,626	$24,022
Identifiable assets:					
Pharmaceutical and hospital products	$ 75,209	$ 69,546	$60,376	$43,658	$35,103
Specialty agricultural chemical products	3,923	3,805	1,801	1,942	1,790
Other health care segments	14,635	14,875	13,902	14,229	12,217
Corporate	5,121	3,424	4,518	3,928	3,770
Discontinued operations	—	—	—	3,370	6,865
Consolidated assets	$ 98,888	$ 91,650	$80,597	$67,127	$59,745

Source: 1978 annual report.

5 Statement of corporate mission:

1. Achieve a position of market leadership through marketing and distribution of consumable and personal products of a perceived differentiation to selected segments of the health care and related fields.
2. Achieve long-term profitable growth through the management of high risk relative to the external environment.
3. Achieve a professional, performance-oriented working environment that stimulates integrity, entrepreneurial spirit, productivity, and social responsibility.

6 In addition to these more general goals, Marion also set a specific sales goal of $250 million. No time frame was established to achieve this goal as the major emphasis was to be placed on the stability and quality of sales.

7 Herman realized, however, that even though there was no written timetable for earnings growth it was well understood that to meet stockholder expectations, the company must grow fairly rapidly.

8 On June 8, 1978, in a presentation before the Health Industry's Analyst

Group, Fred Lyons, Marion's president and chief operating officer, emphasized Marion's commitment to growth. In his remarks he stated:

> We expect to grow over the next 10 years at a rate greater than the pharmaceutical industry average and at a rate greater than at least twice that of the real gross national product. Our target range is at least 10–15 percent compounded growth—shooting for the higher side of that, of course. Obviously we intend to have a great deal of new business and new products added to our current operations to reach and exceed the $250 million level.
>
> Our licensing activities and R&D expenditures will be intensified. . . . At the same time we'll undertake some selective in-house research business into Marion through the acquisition route. It is our intention to keep our balance sheet strong and maintain an A or better credit rating, to achieve a return on investment in the 12–15 percent range, and to produce a net after/tax compared to sales in the 8–12 percent range.

9 To finance this growth in sales Marion was faced with a constant need for funds. Most of these funds in the past had come from the company's operations. To finance a $25 million expansion in its pharmaceutical facilities, the company, in fiscal year 1976, found it necessary to borrow $15 million in the form of unsecured senior notes. The notes were to mature on October 1, 1980, 1981, and 1982 with $5 million due on each of those dates.

10 In regard to possible future financing, Herman made the following comments before the Health Industry's Analyst Group. "Most of you realize that industrial companies have debt-to-equity ratio of 1:1, and if we so desired to lever ourselves to that level, we could borrow $66 million. However, we would keep as a guideline the factor of always maintaining our A or better credit rating, so we would not leverage ourselves that far."

11 Although Marion was fairly light on debt, the potential for future borrowing was not unlimited. Besides maintaining an A credit rating, it was felt that a debt-to-equity ratio greater than 4:1 would be inconsistent with the pharmaceutical industry.

12 To analyze Kalo's future as well as the futures of the other nonpharmaceutical subsidiaries, Herman realized that he and his analysts would have to consider the impact of these financing constraints on Marion's future growth. With unlimited financing in the future he would have only had to make a good investment decision. However, to balance the goals of a strong balance sheet and a high-growth rate, Herman was faced with making the optimal investment decision. It was with these constraints that Herman would eventually have to make his recommendation to the board of directors.

Company history

13 In 1979, Marion Laboratories, Inc., of Kansas City, Missouri, was a leading producer of ethical (prescription) pharmaceuticals for the treatment of car-

exhibit 2
Marion's Major Ethical Pharmaceutical Products

Product	*Product application*	*Estimated market size ($ millions)*	*Marion's product*	*Share of market*
Cerebral and peripheral vasodilators	Vascular relaxant to relieve constriction of arteries	90–100	Pavabid®	22%
Coronary vasodilators	Controlled release nitroglycerin for treatment of angina pectoris	90–100	Nitro-Bid®	12
Ethical and OTC plain antacids	Tablets for relief of heartburn	37	Gaviscon®	26
Andogens-estrogens ...	Product for treatment of calcium deficiencies	12	Os-Cal®	46
Topical burn anti-microbials	Ointment for prevention of infection in third-degree burns	8	Silvadene®	57
Urologic anti-spasmodies	Product for treatment of symptoms of neurogenic bladder	10	Ditropan®	10

Source: Smith, Barney, Harris, Upham and Co., research report, January 19, 1978.

diovascular and cerebral disorders. (See Exhibit 2.) Marion also owned subsidiaries which manufactured hospital supplies, proprietary (nonprescription) drugs, eyeglasses, optical accessories, electrical home stairway elevators, and specialty agricultural chemicals.

14 Marion Laboratories was founded in 1950 by Ewing Marion Kauffman. Prior to establishing his own company, Kauffman held a job with a field sales force of a Kansas City pharmaceutical company. After four years on the job Kauffman's sales efforts were so successful that he was making more money in commissions than the company president's salary. When the company cut his commission and reduced his sales territory, Kauffman quit to establish his own firm.

15 In its initial year of operation the new company had sales of $36,000 and a net profit of $1,000. Its sole product was a tablet called Os-Vim, formulated to combat chronic fatigue. The company's three employees, counting Kauffman, worked from a 13- by 15-foot storeroom that served as manufacturing plant, sales office, warehouse, and headquarters.

16 From the company's inception, the major emphasis for Marion was on sales and marketing. Kauffman was successful in developing an aggressive, highly motivated sales force. During the mid-1960s the company's sales effort was concentrated on developing Pavabid, introduced in 1962, into the leading product in the cerebral and peripheral vasodilator market.

17 While other drug companies were spending large amounts on research and development, hoping to discover new drugs, Marion concentrated on the sales effort, spending very little on basic research. Nearly all of its

research expenditures were directed at improving its current products or further developing products licensed from other drug companies. This particular approach to product development was still being followed in 1979.

18 Beginning in the late 1960s, Marion decided to reduce its dependence on Pavabid which accounted for more than half of Marion's sales. In the pharmaceutical area, the company continued to minimize basic research and worked to develop new drug sources. Marion also began diversifying into the hospital and health products sector primarily by acquiring existing firms in those areas. (See Exhibit 3 for a summary of Marion's acquisition and divestiture activities.) Taking advantage of the high market value of its common stock, the company acquired several subsidiaries engaged in businesses other than pharmaceuticals.[2]

Organization

19 Marion's operations, in 1979, were divided into two separate groups, the Pharmaceutical Group and the Health Products Group. (See Exhibit 4.) The Pharmaceutical Group's operations were a continuation of the original ethical drug line of the company. The Health Products Group was composed of subsidiaries purchased by Marion in hospital and health-related fields.

20 Fred W. Lyons, 41, was president, chief executive officer, and member of the board of directors. As president, Lyons was responsible for the total operation and performance of the corporation. This responsibility included the company's pharmaceutical operating group as well as all subsidiary operations, corporate planning functions, and corporate supportive activities.

21 Lyons joined Marion in 1970 as vice president and general manager, and director. He came to Marion from a similar position with Corral Pharmaceuticals, Inc., a subsidiary of Alcon Laboratories, Inc. Lyons was a registered pharmacist and had received an M.B.A. (master of business administration) degree from Harvard University in 1959.

22 Also serving on the board of directors was senior vice president and chief financial officer, Michael E. Herman, 37, who joined Marion from an investment banking firm of which he was a founding partner. Herman started with Marion as vice president of finance in 1974 and in 1975 was named director of the company. His responsibilities were financial planning, financial control of operations, the management information systems, the treasury functions, product development, and strategic long-range planning. Herman was also chairman of the company's new business task force committee which was responsible for the financial review, planning, evaluation, and negotiation of acquisitions. Herman earned a bachelor of science degree in metallurgical engineering from Rensselaer Polytechnic Institute and an M.B.A. from the University of Chicago.

23 Gerald W. Holder, 48, was the senior vice president in charge of adminis-

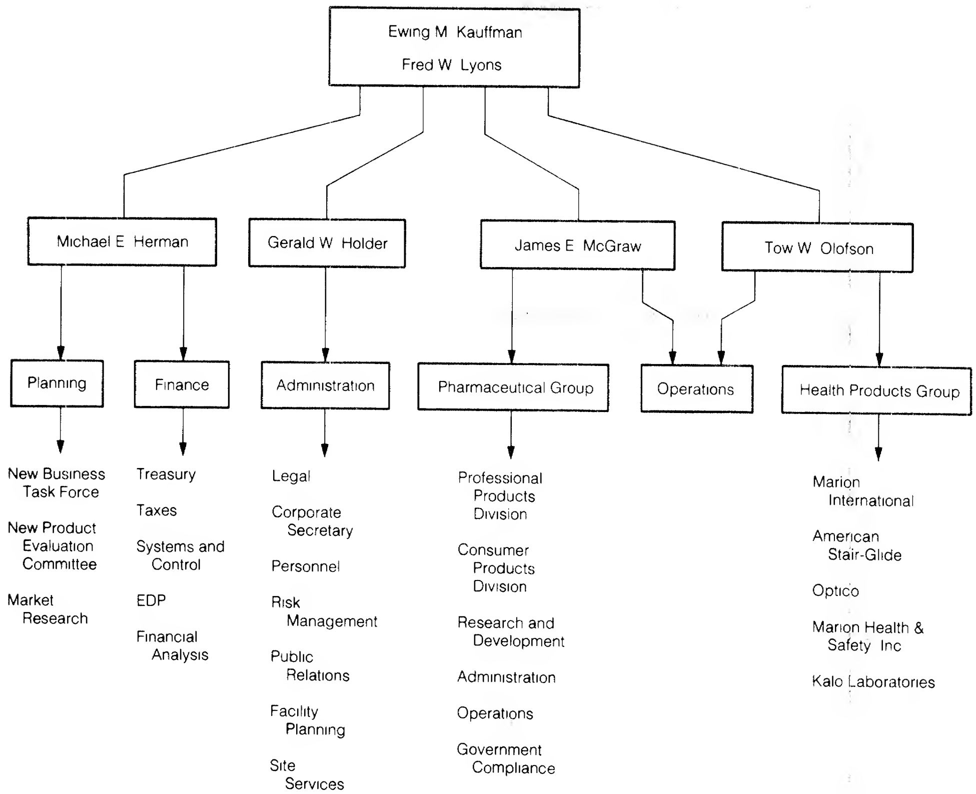
[2] Price-earnings ratios for Marion in 1968 and 1969 were 46 and 52, respectively.

exhibit 3

Summary of subsidiary acquisitions and divestitures

Name of subsidiary	*Type of product(s)*	*Date acquired*	*Date divested*
Marion Health and Safety	First aid and hospital products	1968	—
American Stair-Glide	Manufacturer of home stairway lifts and products to aid the handicapped	1968	—
Kalo Laboratories	Manufacturer of specialty agricultural chemicals	1968	—
Rose Manufacturing	Industrial fall protection devices	1969	Sold: 1978
Mi-Con Laboratories	Manufacturers of opthalmic solutions	1969	Merged into MH&S: 1973
Pioneer Laboratories	Manufacturer of sterile dressings	50% in 1970	Sold out: 1971
Signet Laboratories	Vitamin and food supplements	1971	Discontinued operations, selling some assets: 1975
Optico Laboratories	Eyeglasses, hard contact lenses, and related products	1973	—
Certified Laboratories	Manufacturer IPC products	1969	Sold: 1978
IPC	Marketed IPC products	1969	Merged into Pharmaceutical Division, 1979
Marion International	Distributor of Pharmaceutical Products Inc.	1971	—
Inco	Industrial creams	1972	Merged into MH&S: 1974
Occusafe	Consulting services; re: OSHA regulation and compliance	Incorporated: 1972	Discontinued operations: 1973
Nation Wide Chemical	Specialty ag-chem products	1973	Merged into Kalo
Marion Scientific	Manufacturer and distributor of	Acquired by MH&S: 1973	—
Colloidal	Specialty agricultural products	1973	Merged into Kalo 1974
WBC	Holding company for IPC property	Incorporated: 1976	Sold: 1978
SRC	Specialty ag-chem products	1977	Merged into Kalo

exhibit 4
Organization chart



Organization chart was rendered by authors.

trative functions for Marion. Holder was responsible for all corporate administrative functions, including Marion's legal, personnel, facilities and engineering services, public relations, and risk management staffs. He joined the company in 1973 rising to the senior vice president level in March of 1978.

24 James E. McGraw, 46, was senior vice president of Marion Laboratories, Inc. and president of the company's Pharmaceutical Group. He was responsible for the manufacturing, marketing, quality control, and accounting functions within the two operating units of the Pharmaceutical Group: the Professional Products Division and the Consumer Products Division. McGraw joined Marion in 1974 from a position as president of the General Diagnostics Division of Warner-Lambert Company.

25 Tom W. Olofson, 36, was a senior vice president and president of the Health Products Group. His responsibilities included financial and planning aspects for each of the subsidiaries in the Health Products Group.

26 Within the described organization Marion made some of its operating decisions in small group or task force settings that brought together corporate personnel from several different disciplines. The process of approving certain capital expenditures was an example of the review and analysis process.

27 Marion had a formal capital expenditure review program from expenditure on depreciable assets in excess of $10,000. At the option of the group president, it could also be applied on expenditures less than $10,000 with the modification that in this case only the group president was involved in the review process.

28 A form that forced the requesting individual to discount the cash flows of the project was required to be completed and submitted, if the net present value of cash flows was positive, to a corporate planning group. This group consisted of corporate accounting and facilities planning personnel who, since the company was operating with limited funds, decided which projects, based on financial and strategic considerations, should be forwarded to Fred Lyons for final approval or rejection. This process occurred after the planning period and prior to the purchase of the asset. The capital expenditure review program was used for expenditures in both the Pharmaceutical Group and the Health Products Group.

Pharmaceutical Group

29 Marion's ethical and over-the-counter drug operations were the major components of the Pharmaceutical Group. These operations were split into two divisions, the Professional Products Division and the Consumer Products Division. James E. McGraw headed the Pharmaceutical Group which also was made up of the functions of research and development, administration, operations, and government compliance. Although Marion had been exclusively an ethical drug maker prior to diversification efforts, the company had recently increased its operations in the proprietary drug area.

30 In 1978, Marion formed the Consumer Products Division from what had been International Pharmaceutical Corp. (IPC) to market its growing nonprescription product line. This market area, previously untapped for Marion, was expected to be a major ingredient for near-term growth. To aid in the marketing of its nonprescription line, Marion hired a full-scale consumer advertising agency for the first time in the company's history.

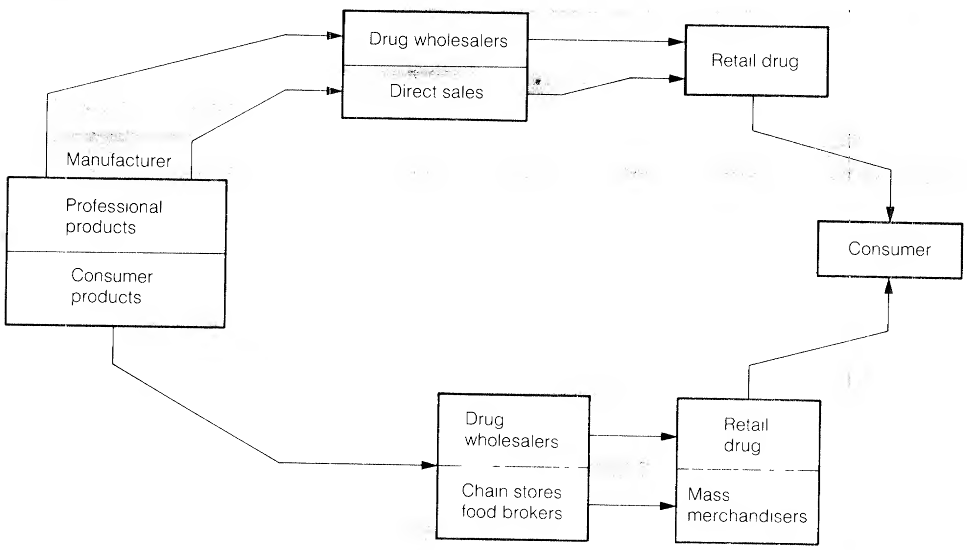
31 Sales for the Consumer Products Division were boosted when, in fiscal 1978, Marion purchased the product Throat-Discs from Warner-Lamberts' Parke-Davis Division. In addition, Marion also purchased two Parke-Davis ethical products, Ambenyl cough-cold products and a tablet for the treatment of thyroid disorders. Because of the timing of the acquisition, most of the sales and earnings were excluded from that year's earnings results. Sales for these three lines were expected to be nearly $8 million in 1979.

32 Marion's ethical pharmaceutical products were marketed by its Profes-

sional Products Division. The company sold its ethical product with a detail sales force of about 200 that called on physicians, pharmacists, and distributors within their assigned territories. The sales force was very productive by industry standards and was motiviated by intensive training and supervision and an incentive compensation system. There was very little direct selling to doctors and pharmacists, the main purpose of the sales visits being promotion of Marion's products. In addition, Marion had an institutional sales force that sold directly to hospitals, institutions, and other large users.

33 In fiscal 1978, 80 percent of Marion's pharmaceutical products were distributed through 463 drug wholesalers. All orders for ethical drug products were filled from the Kansas City, Missouri manufacturing plant. Marion's pharmaceutical distribution system is diagrammed in Exhibit 5.

exhibit 5



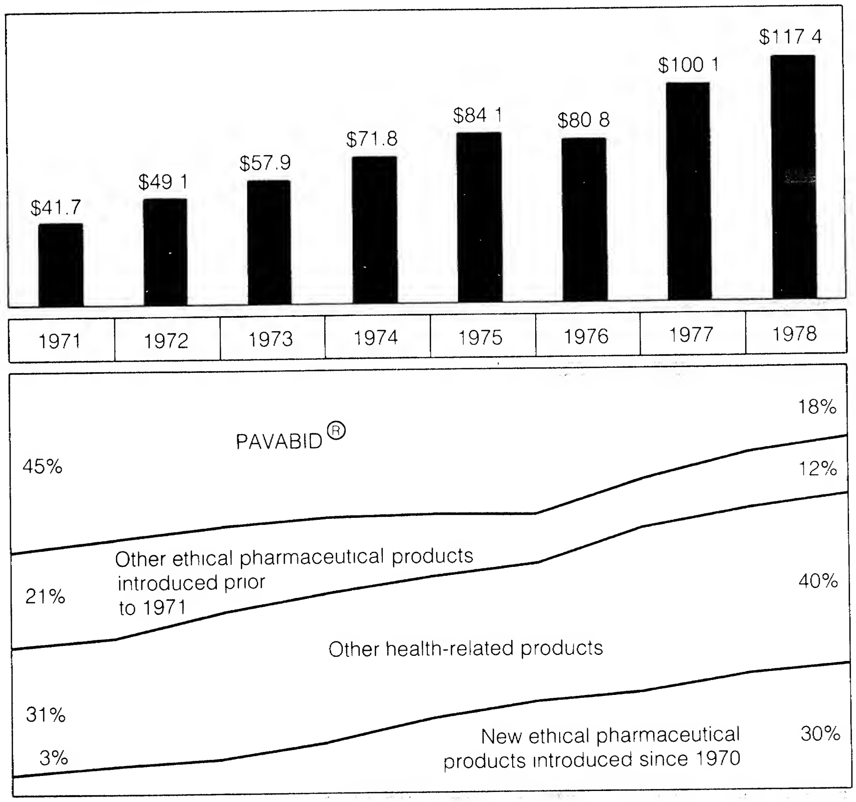
34 During 1978, the company decided to use its improved liquidity position to aid its wholesale drug distributors. Many wholesalers used outside financing to purchase their inventory and were unable to maintain profit margins when interest rates rose. By extending credit on key products, Marion helped its distributors maintain higher inventories and gave the company a selling edge over competitors.

35 One of Marion's major goals for each of its products was for the product to hold a market leadership position in the particular area in which it competed. This goal had been accomplished for most of the company's leading products. (See Exhibit 2.)

36 Capturing a large share of a market had worked particularly well for Marion's leading product, Pavabid, which in 1978 accounted for 18 percent

of the entire company's sales. Marion was decreasing its reliance on Pavabid (see Exhibit 6) which, since its introduction in 1962, had been the company's most successful product. Through the 1960s Pavabid had been responsible for almost all of Marion's growth. In recent years, as the product's market matured, sales growth had slowed, forcing the company to become less dependent on Pavabid. The decrease in sales of 3.9 percent in fiscal year 1976 was due primarily to previous overstocking of Pavabid and the subsequent inventory adjustments at the distributor level.

exhibit 6
Changing product mix



Source: 1978 annual report.

37 In April of 1976 the Food and Drug Administration (FDA) had requested that makers of papaverine hydrochloride (sold by Marion as Pavabid) submit test data to support the safety and efficacy of the drug. Many small manufacturers were not able to submit the data and dropped out of the market. Marion complied with the request and had not yet been notified by the FDA of the outcome of the review by early 1979. A negative action by the FDA was not expected since it had taken so long for a decision and papaverine

had been used safely for decades. However, if the FDA ruled that compounds such as Pavabid could not be marketed, either because they weren't safe or weren't effective, Marion would lose its leading product.

38 In August 1977, the FDA requested that manufacturers of coronary vasodilators, including nitroglycerin compounds like Marion's Nitro-Bid, submit test data to prove product safety and efficacy. This review was the same process that Pavabid was subject to and a negative ruling, although not expected, would adversely affect the company.

39 Proving its products to be safe and effective was only one area in which the company dealt with the FDA. Before any ethical drug product could be marketed in the United States, Marion had to have the approval of the FDA. Under the system effect at that time, the company was required to conduct extensive animal tests, file an investigational new drug application, conduct three phases of clinical human tests, file a new drug application, and submit all its data to the FDA for final review. With the FDA's approval, the drug firm could begin marketing the drug.

40 The approval process from lab discovery and patent application to FDA approval took from 7 to 10 years. Often a company had only seven or eight years of patent protection left to market its discovery and recover the average $50 million it had taken to fully develop the drug from the initial discovery stages.

41 To avoid the R&D expenses necessary to fully develop a new drug entity into a marketable product, Marion's source for new products was a process the company called "search and development." Marion licensed the basic compound from other drug manufacturers large enough to afford the basic research needed to discover new drugs. Generally the licensors, most notably Servier of France and Chugai of Japan, were companies lacking the resources or expertise necessary to obtain FDA approval and marketing rights in the United States. Marion's R&D effort then concentrated on developing a product with an already identified pharmacological action into a drug marketable in the United States. By developing existing drug entities, Marion was able to shorten the development time required to bring a new drug to market at a lower cost than discovering its own drugs. This enabled Marion to compete in an industry dominated by companies many times its own size. (See Exhibits 7 and 8 for drug industry information.)

42 In addition to the FDA, the federal government was also affecting the drug industry with its activities that promoted generic substitution. In early 1979, 40 states had generic substitution that allowed nonbranded drugs to be substituted for branded, and often more expensive, drugs. The U.S. Department of Health, Education and Welfare and the Federal Trade Commission had also recently proposed a model state substitution law and a listing of medically equivalent drugs. Under other federal programs, the maximum allowable cost (MAC) guidelines, reimbursement for Medicaid and Medicare prescriptions was made at the lowest price at which a generic version was available.

exhibit 7
Selected ethical drug companies, 1977 ($000)

	Net sales	*Cost of goods sold*	*R&D expenses*	*Net income**
Pfizer Inc.	$2,031,900	$978,057	$ 98,282	$174,410
Merck & Co.	1,724,410	662,703	144,898	290,750
Eli Lilly & Co.	1,518,012	571,737	124,608	218,684
Upjohn Inc.	1,134,325	—	102,256	91,521
SmithKline Corp.	780,337	299,338	61,777	89,271
G. D. Searle & Co.	749,583	345,224	52,645	(28,390)
Syntex Corp.	313,604	132,710	27,648	37,643
A.H. Robbins Co.	306,713	122,374	16,107	26,801
Rorer Group Inc.	186,020	59,606	5,174	18,143
Marion Laboratories	100,131	37,330	5,907	10,652

* Aftertax.
Source: *Drug and Cosmetic Industry*, June 1978.

exhibit 8
Ethical drug industry composite statistics

	1978	*1977*	*1976*	*1975*
Sales ($ millions)	$12,450	$10,859	$10,033	$9,022
Operating margin (%)	22.5%	22.2%	21.9%	22.1%
Income tax rate (%)	36.5	36.4	36.2	36.7
Net profit margin (%)	11.8	11.7	11.7	11.6
Earned on net worth (%)	18.5	17.9	18.2	18.4

Source: Value Line Investment Survey.

43 Generics accounted for 12 percent of new prescriptions being written and were likely to increase in relative importance. To combat the decreasing profit margins that were expected, the industry was looking to its ability to develop new drugs to offset the expected shortfall that was expected in the 1980s caused by a loss of patent protection on many important drug compounds.

44 The effect that generic substitution laws would have on Marion was unclear. The company had always concentrated on products with a unique pharmacological action rather than those that were commodity in nature. Generic subsitution required an equivalent drug be substituted for the brand name drug and there were uncertainties about how equivalency would be defined.

45 Marion's pharmaceutical operations had not produced a major new product for several years. Products that were in various stages of development were diltiazen hydrochloride, an antianginal agent; sucralfate, a nonsystematic (doesn't enter the bloodstream) drug for the treatment of ulcers; and benflourex, a product that reduced cholesterol levels in the blood.

Health Products Group

46 Subsidiaries selling a wide range of products used in health care and related fields made up Marion's Health Products Group. The company had bought

and sold several subsidiaries since beginning to diversify in 1968 (see Exhibit 3). By 1978 the group of subsidiaries was responsible for 39 percent of total company sales and 22 percent of earnings before taxes.

47 Several times after purchasing a company Marion had decided to sell or discontinue operations of a subsidiary. The divestment decision in the past had been based on considerations such as a weak market position, low-growth position, excessive product liability, or a poor fit with the rest of Marion.

48 In his presentation before the Health Industry's Analyst Group, Fred Lyons noted the importance of a subsidiary fitting in with the rest of Marion when explaining the company's decision to sell Rose Manufacturing.

> You may have noticed that during this past year we determined through our strategic planning that Rose Manufacturing, in the fall-protection area of industrial safety, did not fit either our marketing base or our technology base. Therefore we made a decision to spin Rose off, and we successfully culminated its sale in November of 1977. Rose, like Signet Laboratories three years ago, just did not fit.

49 In adjusting its corporate profile Marion was always searching for companies that provided good investment potential and were consistent with the company's goals. To provide a framework within which to evaluate potential acquisitions and to avoid some of the mistakes made in past purchases, Marion developed a set of acquisition criteria to be applied to possible subsidiary investments.

Search criteria for acquisitions

Product area:	Health care
Market:	$100 million potential with 8 percent minimum growth rate
Net sales:	$3–30 million
Tangible net worth:	Not less than $1 million
Return on investment:	Not less than 20 percent pretax
Method of payment:	Cash or stock

50 The board of directors made the ultimate decision on the acquisitions and divestment of Marion's subsidiaries. At the corporate level, Herman was responsible for evaluating changes in the corporate portfolio and based on his analysis making recommendations to the board. Since Herman was also on the board of directors his recommendations were heavily weighted in the board's final decision.

51 In early 1979 Marion had four subsidiaries in its Health Products Group, Marion Health & Safety, Inc., Optico Industries, American Stair-Glide, and Kalo Laboratories. Following is a brief description of each:

52 *Marion Health & Safety, Inc.,* sold a broad line of hospital and industrial safety products through its Marion Scientific Corp. and Health and Safety Products Division. Recently introduced, Marion Scientific products (a consumer-oriented insect bite treatment and a device for transporting anaerobic

cultures) both showed good acceptance and growth in their respective markets. Distribution is generally through medical/surgical wholesalers and distributors who in turn resell to hospital, medical laboratories, reference laboratories, etc. Health and Safety Division manufactures and/or packages primarily safety-related products (hearing protection, eye-wash, etc.) and first-aid kits and kit products, such as wraps, Band-Aids, and various OTC products. Sale of these products is made to safety equipment wholesalers/ distributors who resell to hospital, industry, institutions, etc. Sales of Marion Health & Safety, Inc. were estimated to have increased about 17 percent, by outside analysts, to a level estimated at $19 million. Pretax margins were about 10 percent in this industry. Marion Health & Safety, Inc. was headquartered in Rockford, Illinois.

53 *Optico Laboratories, Inc.*, participated in the wholesale and retail optical industry. Its main products were glass and plastic prescription eyeglass lenses and hard contact lenses. Outside analysts estimated this subsidiary recorded sales gains of about 26 percent for 1978 for sales estimated to be about $8 million. Optico had reduced profitability during 1978 due to expansion of its retail facilities. Pretax margins for 1978 were estimated at 6 percent, but this was expected to improve when the expansion program was completed. Optico's headquarters were located in Tempe, Arizona.

54 *American Stair-Glide Corp.* manufactured and marketed home stairway and porch lifts and other products to aid physically handicapped individuals. These products were principally sold to medical/surgical supply dealers for resale or rental to the consumer. In some instances distribution is through elevator companies. Sales were estimated at about $5 million annually by outside analysts. This subsidiary was expected to grow slowly and steadily and it had a very stable historical earnings pattern. The trend for greater access to buildings for the handicapped was expected to impact favorably on this Grandview, Missouri based subsidiary.

55 *Kalo Laboratories, Inc.*, operated in the specialty agricultural chemical market and provided products to meet specialized user needs. In the past, Kalo had been successful in marketing its line of specialty products. (See Exhibit 9—Kalo's past earnings information). In assessing Kalo's future there were many risks to consider. These risks included competition from large chemical companies, governmental regulatory actions, and uncertain future product potentials.

Competition and industry

56 The U.S. and Canadian agricultural chemical market was estimated to be $3.2 billion in 1978 and growing at more than 15 percent a year.[3] The industry was dominated by large chemical manufacturers including Dow Chemical, DuPont, Stauffer Chemical, and Gulf Oil. The market was also shared

[3] 1979 DuPont annual report; and 1979 UpJohn annual report.

exhibit 9
Kalo Laboratories sales and earnings information ($ millions)

	1978	*1977*	*1976*	*1975*	*1974*	*1973*
Sales	$ 9	$ 5	$ 2	$ 4	$ 3	$ 2
Cost of goods sold, (percent of sales)	43%	54%	61%	53%	55%	48%
Expenses:						
R&D expense	8	7	7	5	5	3
Marketing, selling, and general administrative expenses	37	31	42	23	24	27
Total expenses	45%	38%	49%	28%	29%	30%
Total assets	$ 5	$ 4	$ 2	$ 2	$ 2	$ 1
Total investment*	3	3	1	1	1	.5

* Includes Marion's equity in Kalo and funds lent on a long-term basis.
Based on authors' estimates.

by large ethical drug manufacturers including Eli Lilly, Pfizer, and UpJohn. (See Exhibit 10 for agriculture-related sales.) Economics of scale allowed the larger companies to produce large amounts of what might be perceived as a commodity product (herbicides, insecticides, and fungicides) at a much lower cost per unit than the smaller companies. Diversification of and within agricultural product lines assured the larger manufacturers even performance for their agricultural divisions as a whole.

exhibit 10
Total and agriculture-related sales, selected companies, 1979

	Total sales ($ millions)	*Agriculture related*	
		Sales ($ millions)	*Earnings (before tax)*
Eli Lilly	$2,520	$920*	28.6%
Pfizer	3,030	480*	9.8
Upjohn	1,755	280*	9.2
Marion (1978)	100	9	9.0

* Includes international sales.
Source: Value Line Investment Survey.

57 Since smaller chemical companies like Kalo could not afford to produce large enough amounts of their products to match the efficiency and prices of the large companies these firms concentrated on specialty markets with unique product needs. By identifying specialty chemical needs in the agricultural segment Kalo was able to produce its products and develop markets that were very profitable but weren't large enough to attract the bigger firms.

Products

58 Since the larger chemical companies dominated the large product segments, Kalo's products were designed to meet the specialized needs of its agricul-

tural users. Kalo's product line was divided into four major classes, seed treatments, adjuvants, bactericides, and herbicides.

59 Seed treatments for soybeans accounted for the majority of Kalo's sales. One product in this area was Triple Noctin. Products in the seed treatment class were intended to act on soybean seeds to increase their viability once in the ground. Kalo manufactured seed treatments for soybeans only.

60 Adjuvants were chemicals that, when added to another agricultural product, increased the efficacy of the product or made it easier to use. For instance, Biofilmo prevented liquid fertilizer from foaming which made it easier to apply and Hydro-Wet enhanced the soils' recaptiveness to certain chemicals, which reduced runoff into surrounding areas.

61 The newest product for Kalo was the adjuvant Extend, a chemical compound added to fertilizer that made it bind chemically with the soil or the plant. The binding process helped retain the fertilizer where it was applied making each application longer lasting and more effective. Extend was only recently introduced and its success was difficult to assess at such an early stage. Kalo's management was planning to build a family of products around Extend. Sales projections showed Extend contributing between 60–70 percent of Kalo's future growth through 1987.

62 Bactericides and herbicides were the final two product classes at Kalo. Bactericides were applied to the soil to either inhibit or encourage the growth of selected bacteria. One product, Isobac was used to control boll rot in cotton. Herbicides, mainly for broadleaf plants, were used to control or kill unwanted weeds leaving the desirable crop unharmed.

63 In the past, Kalo had acquired several of its products by acquiring the company that manufactured the product. When it purchased a going concern intact, Kalo was able to gain both manufacturing facilities and an existing distribution system. In the future Kalo expected to diversify its product line in a similar fashion. To enlarge its existing product lines Kalo was planning to use both internal and contract R&D. An example of enlarging the product family was the planned adaptation of its products to different numerous crop application.

64 Because Kalo did not have a well-diversified product line its operations were more cyclical than the overall agricultural sector. Two major factors beyond Kalo's control made its annual performance extremely unpredictable, the weather and spot prices for commodities.

65 Kalo's operating results were seasonal as its products were primarily intended to be applied in the spring months. It was not unusual for the subsidiary to show a net loss from operations for the nine months from July until March and show a large profit in the three months April, May, and June when the products were being purchased for immediate application. If the spring months were particularly rainy Kalo's profitability was adversely affected. Heavy farm equipment couldn't operate on wet fields without getting stuck and application was impossible until the fields dried out. Once the fields were dry, Kalo's agricultural users often did not have time to apply the

herbicides or other products even though it would have been economically advantageous to do so.

66 The other factor that affected the demand for Kalo's products was the spot pricing of commodities. The price of commodities relative to each other had a large effect on the total amount of each type of crop planted. Because the producer was free to switch crops yearly based on the spot prices, Kalo's demand for the upcoming planting season was uncertain and variable. Kalo was particularly vulnerable to swings in demand caused by the substitutability of crops since many of their products were applicable only to soybeans.

Distribution and marketing

67 The end user of Kalo's products was usually the individual farmer. Kalo and the rest of the agricultural chemical industry had a distribution system like the one shown below.

Manufacturer → Wholesaler or super distributor → Retailer → Farmer

↓

Applicator
(if special
equipment needed)

68 Kalo promoted its products with a sales force of about 30 salesmen. The main task of these salesmen was to call on and educate wholesalers/distributors on the advtanges, unique qualities, and methods of selling Kalo's products. In addition some end-user information was distributed to farmers, using pull advertising to create demand. A limited amount of promotion was done at agricultural shows and state fairs, but because of the expense involved this type of promotion was not used often.

Kalo's future

69 Sales forecasts prepared by the staff analysts for Herman looked very promising as they predicted sales gains of from $4–6 million in each of the next nine years. (See Exhibit 11.) There were, however, some important assumptions on which the forecasts were based.

70 As mentioned earlier 60–70 percent of the forecasted growth was to come from a product family based on the new product *Extend*. A great deal of uncertainty surrounded the product, however. Since it was new, the current success of *Extend* was difficult to measure particularly in determining how

exhibit 11
Kalo Laboratories sales forecast (current $ millions)

	1978	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*
Net sales	9	12	16	20	25	30	35	40	45	50

Based on casewriters' estimates.

current sales translated into future performance. If the market evaluation for *Extend* and related products were correct, and if a family of products could be developed around *Extend* then the sales potential for the proposed product family was very promising provided Kalo was able to exploit the available sales opportunities.

71 Additional growth projected in the sales forecasts was to come from existing products and undefined future products that were to be developed or acquired. Approximately 20 percent of the growth was to come from the existing products in the next four to five years. Ten to 20 percent of the growth in the later years of the forecast was expected to come from currently unknown products.

72 For Kalo to realize the forecasted growth it was going to be necessary for Marion to provide financing. It was going to be impossible for Kalo to generate all the required funds internally. Kalo had been a net user of cash, provided by Marion, since 1976. (See Exhibit 9 and Exhibit 12 for information about Marion's investment in Kalo.) Marion's management did not consider the amount of cash provided through the first part of 1979 to be excessive so long as Kalo maintained adequate profitability and steady growth rates. In addition to the long-term funds provided by Marion, Kalo also required short-term financing of inventory during each year due to the seasonality of its sales.

exhibit 12

KALO LABORATORIES
Balance Sheet
For June 30, 1978
($ millions)

Current assets:	$2.5	Current liabilities:	$1.4
Plant property, and equipment (net)	1.9	Long-term debt	1.0
Other	.2	Capital	2.2
Total	$4.6	Total	$4.6

Based on casewriters' estimates.

Government regulation

73 Another major uncertainty in Kalo's future was an unpredictable regulatory climate. Regulation of agricultural chemicals was under the jurisdiction of the Environmental Protection Agency (EPA). Compliance with the EPA was a similar process as with the FDA. The process of developing and introducing a new chemical product took from 8–10 years which included 2–5 years necessary to obtain EPA approval. The costs of developing and brining a new product to market were generally from $5–10 million.

74 Once a product was on the market and the EPA had powers of recall similar to the FDA and could require the company to do additional research after the product was introduced. The prospect of having a product removed from the market was an added element of risk for Kalo if any of its products

exhibit 13

MARION LABORATORIES INC.
Conslidated Balance Sheet
For 1977 and 1978

Assets	*1978*	*1977*
Current assets:		
Cash	$ 381,116	$ 961,588
Short-term investments, at cost which approximates market	2,561,660	10,028,297
Accounts and notes receivable, less allowances for returns and doubtful accounts of $1,845,466 and $2,305,793	28,196,199	20,576,412
Inventories	19,640,945	15,568,170
Prepaid expenses	2,305,403	1,461,367
Deferred income tax benefits	757,585	895,110
Total current assets	53,842,908	49,490,944
Property, plant and equipment, at cost:		
Land and land improvements	2,832,588	2,935,671
Buildings	24,458,746	25,224,652
Machinery and equipment	19,671,607	18,110,907
Aircraft and related equipment	1,670,904	1,670,904
Construction in progress	365,311	357,338
Total plant, property, and equipment	48,999,156	48,299,472
Less accumulated depreciation	10,725,533	8,585,190
Net property, plant, and equipment	38,273,623	39,714,282
Other assets:		
Intangible assets	4,774,055	2,042,762
Notes receivable (noncurrent)	890,692	11,589
Marketable equity securities, at market value	688,914	—
Deferred income tax benefits (noncurrent)	318,434	249,647
Miscellaneous	99,597	141,232
Total other assets	6,771,692	2,445,230
Total assets	$98,888,223	$91,650,456

Liabilities and Stockholders' Equity	*1978*	*1977*
Current liabilities:		
Current maturities of long-term debt	$ 82,102	$ 95,004
Accounts payable, trade	3,979,341	4,224,105
Accrued profit sharing expense	1,752,515	243,096
Other accured expenses	3,864,168	3,008,238
Dividends payable	1,260,612	1,198,938
Income taxes payable	4,391,252	5,030,219
Total current liabilities	15,329,990	13,799,600
Long-term debt, excluding current maturities	15,580,072	15,661,399
Deferred income taxes payable	1,107,000	733,000
Deferred compensation	177,975	172,889
Stockholders' equity:		
Preferred stock of $1 par value per share:		
Authorized 250,000 shares; none issued	—	—
Common stock of $1 par value per share:		
Authorized 20 million shares; issued 8,703,346 shares	8,703,346	8,703,346
Paid-in capital	3,474,358	3,475,443
Retained earnings	58,358,925	51,604,550
	70,536,629	63,783,339
Less:		
293,153 shares of common stock in treasury, at cost (189,500 shares in 1977)	3,819,243	2,499,771
Net unrealized loss on noncurrent marketable equity securities	24,200	—
Total stockholders' equity	66,693,186	61,283,568
Commitments and contingent liabilities	—	—
Total liabilities and stockholders' equity	$95,888,223	$91,650,456

Source: 1978 annual report.

exhibit 14

MARION LABORATORIES INC.
Ten-Year Financial Summary
($000, except per share data)

	1978	1977	1976	1975	1974	1973	1972	1971	1970	1969
Sales:										
Net sales	$117,378	$100,131	$80,838	$84,096	$71,778	$57,937	$49,066	$41,692	$35,322	$30,188
Cost of sales	43,177	37,330	29,315	26,078	21,715	18,171	14,932	12,262	10,622	8,985
Gross profit	74,201	62,801	51,523	58,018	50,063	39,766	34,134	29,430	24,700	21,203
Operating expenses	51,718	43,397	37,292	31,699	26,991	21,155	19,164	17,181	13,828	12,453
Operating income	22,483	19,404	14,231	26,319	23,072	18,611	14,970	12,249	10,872	8,750
Other income	1,581	1,194	683	1,404	1,033	722	709	599	630	328
Interest expense	1,546	1,542	898	97	83	109	116	88	198	260
Earnings:										
Earnings from continuing operations before income taxes	22,518	19,056	14,016	27,626	24,022	19,224	15,563	12,760	11,304	8,818
Income taxes	10,804	8,404	5,628	13,295	11,791	9,297	7,730	6,364	5,899	4,493
Earnings from continuing operations	11,714	10,652	8,388	14,331	12,231	9,927	7,833	6,396	5,405	4,325
Earnings (loss) from discontinued operations	—	—	—	(3,617)	(120)	76	488	—	—	—
Net earnings	$ 11,714	$ 10,652	$ 8,388	$10,714	$12,111	$10,003	$ 8,321	$ 6,396*	$ 5,405	$ 4,325
Common share data:										
Earnings (loss) per common and common equivalent share:										
Continuing operations	$ 1.38	$ 1.23	$ .96	$ 1.65	$ 1.40	$ 1.14	$ .90	$ .76	$ .65	$ .52
Discontinued operations	—	—	—	(.42)	(.01)	.01	.06	—	—	—
Net earnings	$ 1.38	$ 1.23	$ .96	$ 1.23	$ 1.39	$ 1.15	$ .96	$ .76*	$ .65	$ .52
Cash dividends per common share	$ .59	$ .53	$ .52	$ .48	$ .28	$ .21	$ .20	$ .16	$ .12	$ .12
Stockholders' equity per common and common equivalent share	$ 7.87	$ 7.09	$ 6.63	$ 6.29	$ 5.52	$ 4.16	$ 3.16	$ 2.52	$ 2.01	$ 1.47
Weighted average number of outstanding common and common share equivalents	8,475	8,640	8,707	8,708	8,689	8,715	8,651	8,396	8,377	8,354

* Before extraordinary charge of $916,000, equal to 11 cents per common share resulting from the disposition of investment in affiliated companies.
Source: 1978 annual report.

were affected. No problems were expected for Kalo although several of the subsidiary's products (particularly its herbicides and bactericides) had a relatively high potential for environmental problems, if not applied correctly.

The decision

75 Herman knew that in making his recommendation he would have to balance the immediate and long-term resource needs and the goals of Marion. Although Kalo looked promising from the forecasts, there were many uncertainties surrounding the subsidiary's future that had to be considered.

76 Since Marion had no new drug products ready to be introduced soon, the company would have to rely on other areas of the company to reach its growth goals. Kalo was growing, but it was also requiring a constant input of funds from its parent.

77 One possibility for growth was to purchase another drug manufacturer and add its products to Marion's taking advantage of any distribution synergies that might exist. To make such a purchase, the company would need more resources. To sell a subsidiary could provide needed resources, but to do so quickly under less than optimum conditions would surely result in a significantly lower price than could be realized under normal conditions. The income and cash flow impact of this approach would be undesirable.

78 With the board meeting so soon, Herman was faced with analyzing the complex situation quickly. In three days he would have to make his recommendation to the board of directors.

case 23

Hewlett-Packard: A 1975–1978 review

1 In May 1978 John Young was appointed chief executive of Hewlett-Packard. He was simultaneously handed the difficult task of charting a path through a rapidly growing and increasingly complex competitive jungle. Forbes reported that Young would be paid $280,000 to lead the classy electronics company into the rapidly changing, new computer market in which the biggest competitor (IBM) had vastly greater resources.[1] Although handpicked by the company's two founders, Bill Hewlett and Dave Packard, who between them owned 39 percent of the stock, he would be watched carefully. Whether he could continue the growth, the success, and the same egalitarian leadership style of his predecessors was a real question. Whether he should even try to adopt the same general strategy and tactics of recent years was also a real question.

2 This case depicts some of the major facets of the 1975–1978 transitionary period for Hewlett-Packard. In summary, the period appears to have been marked by a continuation of impressive growth; by repeated affirmation of, and only slight changes in, the company's basic objectives and policies; by a smooth transfer of top executive responsibilities; and by a changing product mix and marketing strategy which had brought Hewlett-Packard into increasingly more competitive markets and direct confrontation with IBM and other major computer companies.

Hewlett-Packard: A brief sketch

3 Innovative products have been the cornerstone of Hewlett-Packard's growth since 1939, when Hewlett engineered a new type of audio oscillator and, with Packard, created the company in Packard's garage. The product was cheaper and easier to use than competitive products, and it was quickly followed by a family of test instruments based on the same design principles. Hewlett-Packard has since become one of the giants of the high-technology electronics industry. Their products include electronic test and measuring systems; medical electronic products; electronic instrumentation for chemical analysis; and solid-state components. According to company sources, Hewlett-Packard has remained a people-oriented company with manage-

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This case was prepared by Roger M. Atherton and Dennis M. Crites, assisted by Gail Greenberg, all of the University of Oklahoma. Reprinted with permission of the Case Research Association.

[1] "Welcome to the Hot Seat, John Young," *Forbes,* July 24, 1978, pp. 62–63.

ment policies that encourage individual creativity, initiative, and contribution throughout the organization. It has also tried to retain the openness, informality, and unstructured operating procedures that marked the company in its early years. Each individual has been given the freedom and the flexibility to implement work methods and ideas to achieve both personal and company objectives and goals.

4 Both Hewlett and Packard have indicated that their corporate objectives, first put into writing in 1957 and modified occasionally since then, have served the company well in shaping the company, guiding its growth, and providing the foundation for its contribution to technological progress and the betterment of society. Last updated in 1977, the corporate objectives were, according to company sources, remarkably similar to the original versions developed from management concepts formulated by Hewlett and Packard in the company's early years.[2]

5 The following is a brief listing of the Hewlett-Packard (HP) objectives in 1978.

1. Profit objective: To achieve sufficient profit to finance our company growth and to provide the resources we need to achieve our other corporate objectives.
2. Customer objective: To provide products and services of the greatest possible value to our customers, thereby gaining and holding their respect and loyalty.
3. Fields of interest objective: To enter new fields only when the ideas we have, together with our technical, manufacturing, and marketing skills, assure that we can make a needed and profitable contribution to the field.
4. Growth objective: To let our growth be limited only by our profits and our ability to develop and produce technical products that satisfy real customer needs.
5. People objective: To help HP people share in the company's success, which they make possible; to provide job security based on their performance; to recognize their individual achievements; and to help them gain a sense of satisfaction and accomplishment from their work.
6. Management objective: To foster initiative and creativity by allowing the individual great freedom of action in attaining well-defined objectives.
7. Citizenship objective: To honor our obligations to society by being an economic, intellectual, and social asset to each nation and each community in which we operate.

[2] "Revised Corporate Objectives," *Measure,* May 1977, pp. 7–10.

6 Except for slight changes in wording, the objectives were the same as in 1975.

The 1973–1974 redirection

7 Adversely affected by computer and aerospace downturns in 1970, Hewlett-Packard had at first welcomed the 30 percent increase in sales in 1972 and the 40 percent increase in 1973. Problems arose, however, as inventories and accounts receivable increased substantially. A 32 percent increase in employees to handle the increased sales, administrative, and manufacturing activities required extensive training efforts and organizational readjustments. Some products were put into production before they were fully developed. Prices were sometimes set too low for an adequate return on investment. Short-term borrowing increased substantially to $118 million and management seriously considered converting some of its short-term debt to long-term debt, a practice the company had traditionally avoided, preferring to operate on a pay-as-you-go basis.

8 In 1973–74, top management decided to avoid adding long-term debt and to reduce short-term debt by controlling costs, managing assets, and improving profit margins. As Packard made clear to the management at all levels, they had somehow been diverted into seeking market share as an objective. So both he and Hewlett began a year-long campaign to reemphasize the principles they developed when they began their unique partnership. Packard toured the division to impose this new asset-management discipline. In addition, while other companies dropped prices to boost sales and cut research spending to improve earnings, Hewlett-Packard used quite different tactics. It raised prices by an average of 10 percent over the previous year, and it increased spending on research and development by 20 percent, to an $80 million annual rate. These two strategies were intended to improve company profitability, to slow the rate of growth that had more than doubled sales in the previous three years, and to enable it to compete primarily on the basis of quality and technological superiority.

9 The improvements in 1974 performance compared with 1973 were quite dramatic. During fiscal 1974, inventories and receivables increased about 3 percent while sales grew 34 percent to $884 million. The effect of this better asset control combined with improved earnings, resulted in a drop in short-term debt of approximately $77 million. Earnings were up 66 percent to $84 million and were equal to $3.08 per share compared to $1.89 per share. Only 1,000 employees were added compared to 7,000 in the previous year.

10 Both Hewlett and Packard were reportedly dismayed that they had been forced to initiate and personally lead the efforts to get the company back on the track. It was particularly disconcerting to them because they believed the issues were fundamental to the basic strategy of the company. They had also had to intervene directly in day-to-day operational management, which was counter to their basic philosophy of a decentralized, product-oriented, and divisionalized organization structure.

Growth, 1975–1978

11 The dramatic growth that followed the 1973–74 redirection was in essence maintained through the 1978 fiscal year. The sales increase from $981 million in 1975 to $1.73 billion in 1978 averaged almost 21 percent per year. Net earnings, growing from $84 million in 1975 to $153 million in 1978, averaged 22 percent per year with an 8 percent increase in 1975–76, a 33 percent jump in 1976–77, and a 1977–78 growth of 26 percent. A four-year consolidated earnings summary, strategic ratios, financial ratios, contributions to sales and earnings by business segments, and a percent of sales analysis are presented in Exhibits 1, 2, 3, and 4. Total employees, about 29,000 at the beginning of the 1975 fiscal year, grew about 11 percent a year to a level of about 42,400 at the end of the 1978 fiscal year. The total number of products increased from roughly 3,400 in late 1975 to over 5,000 in mid-1978. The number of new product introductions increased significantly from about 90 major new products in 1975 to 130 in 1978. In keeping with its traditional attention to research and development, these expenditures grew from $90 million in fiscal 1975 to $154 million in fiscal 1978. Data on growth are given in Exhibit 5.

exhibit 1

HEWLETT-PACKARD COMPANY
Consolidated Earnings Summary
For the Years Ended October 31, 1975–1978
($ millions)

	1975	*1976*	*1977*	*1978*
Net sales	$981.2	$1,111.6	$1,360.0	$1,728.0
Other income, net	8.3	12.0	13.9	23.0
Total revenues	989.5	1,123.6	1,373.9	1,751.0
Costs and expenses:				
Cost of goods sold	462.7	535.6	622.2	805.0
Research and development	89.6	107.6	125.4	154.0
Marketing	162.0	176.6	207.5	264.0
Administrative and general	124.5	139.1	185.4	226.0
Interest	2.2	4.1	4.2	6.0
Total costs and expenses	841.0	963.0	1,144.7	1,455.0
Earnings before taxes on income	148.6	160.6	229.2	296.0
Taxes on income	65.0	69.8	107.7	143.0
Net earnings	$ 83.6	$ 90.8	$ 121.5	$ 153.0
Earnings per share:				
Net earnings	$ 3.02	$ 3.24	$ 4.27	$ 5.27
Cash dividends	.25	.30	.40	.50
Common shares outstanding at year-end	27.6	28.0	28.5	29.0

Note: Figures may not add exactly due to rounding.
Source: Hewlett-Packard annual reports, 1975–1978.

exhibit 2
Strategic and financial ratios

A. Strategic ratios

	Net earnings / Total revenues	×	Total revenues / average assets	=	Net earnings / average assets	×	Average assets / average net worth	=	Net earnings / average net worth
1975	8.5%	×	1.39	=	11.8%	×	1.39	=	16.4
1976	8.1	×	1.32	=	10.6	×	1.38	=	14.7
1977	8.8	×	1.31	=	11.6	×	1.40	=	16.2
1978	8.7	×	1.34	=	11.7	×	1.44	=	16.8

B. Financial ratios

	1975	*1976*	*1977*	*1978*
Current ratio	2.51	2.62	2.58 *(a)*	2.29
Acid test	1.36	1.59	1.62	1.44
Collection period (days)	75	76	72 *(b)*	77
Accounts payable T/0 (days)	25	21	27	32
Inventory T/0	2.31	2.42	2.41	2.54
Debt to net worth	.33	.35	.37 *(c)*	.42
Interest coverage	66.9	38.2	53.6	48.3
Gross profit margin	.53	.52	.54	.53
Net profit to net sales	.086	.082	.089 *(d)*	.089

Note: *Dun's Review*'s (December 1977) figures are the averages of the electronic component and scientific instrument business lines. Comparable figures for 1978 were not published.
(a) *Dun's Review* indicated the industry median was 2.64.
(b) *Dun's Review* indicated the industry median was 65.
(c) *Dun's Review* indicated the industry median was .85.
(d) *Dun's Review* indicated the industry median was .047.
Source: Developed by casewriters from Hewlett-Packard annual reports, 1975–1978.

exhibit 3

HEWLETT-PACKARD COMPANY
Contributions to Sales and Earnings
For the Years Ended October 31, 1975–1978
($ Millions)

	1975	*1976*	*1977*	*1978*
Sales:				
Test, measuring, and related items	$ 453	$ 501	$ 593	$ 740
Electronic data products	395	453	580	761
Medical electronic equipment	99	119	135	163
Analytical instrumentation	53	58	76	98
Total sales	1,000	1,131	1,384	1,762
Less sales between business segments	(19)	(19)	(24)	(34)
Net sales to customers	$ 981	$1,112	$1,360	$1,728
Earnings:				
Test, measuring, and related items	$ 94	103	$ 134	$ 180
Electronic data products	68	69	106	124
Medical electronic equipment	13	21	22	26
Analytical instrumentation	8	7	12	16
Operating Profit	183	200	274	346
Less eliminations and corporate items	(34)	(39)	(45)	(50)
Earnings before taxes on income	$ 149	$ 161	$ 229	$ 296

Source: Hewlett-Packard annual reports, 1975–1978.

exhibit 4
Percent of sales analysis

	1975	1976	1977	1978
Earnings:				
Cost of goods sold	46.8%	47.7%	45.3%	46.0%
Research and development	9.1	9.6	9.1	8.8
Marketing	16.4	15.7	15.1	15.1
Administrative and general	12.6	12.4	13.5	12.9
Interest	.2	.4	.3	.3
Total costs and expenses	85.0	85.7	83.3	83.1
Earnings before income taxes	15.0	14.3	16.7	16.9
Taxes	6.6	6.2	7.8	8.2
Net earnings	8.5%	8.1%	8.8%	8.7%
Sales by business segment (percent of total):				
Test, measuring, and related	45.3%	44.3%	42.8%	42.0%
Electronic data products	39.5	40.1	41.9	43.2
Medical electronic equipment	9.9	10.5	9.8	9.3
Analytical instrumentation	5.3	5.1	5.5	5.6
Earnings by business segment (percent of total):				
Test, measuring, and related	51.4	51.5	48.9	52.0
Electronic data products	37.2	34.5	38.7	35.8
Medical electronic equipment	7.1	10.5	8.0	7.5
Analytical instrumentation	4.4	3.5	4.4	4.6

Note: Figures may not add exactly due to rounding.
Source: Developed by casewriters from Exhibits 1 and 3 in the case.

exhibit 5
Selected growth indicators for years ended October 31, 1975–1978

	1975	1976	1977	1978
Employees				
Domestic	22,000	22,800	25,400	31,000
International	8,200	9,400	9,700	11,400
Total	30,200	32,200	35,100	42,400
Total customers	35,000	n.a.	Over 50,000	n.a.
Domestic orders (millions)	$500.4	$592.4	$768.8	$977.0
International orders (millions)	$501.3	$557.6	$664.1	$898.0
Backlog of orders (millions)	$145	$175	$252	n.a.
R&D expenditures (millions)	$ 89.6	$107.6	$125.4	$154.0
Patents held and pending	770/151	837/158	850/165	n.a.
Number of products	~3,400	~3,600	~4,000	~5000
Major new products introduced	~90	~100	~115	~130
Capital expenditures (millions)	$ 66	$103.4	$115.5	$159.0
Increases in plant capacity (sq. ft.)	760,000	768,000	696,000	741,000
Increases in sales and service (sq. ft.)	n.a.	175,000	183,000	253,000

n.a. = Not available.
Source: Hewlett-Packard annual reports, 1975–1978, form 10-Ks, and correspondence with HP.

Structure

12 In a 1978 statement of philosophy, HP emphasized as a basis for high-level achievement their provision of a realistic and simple set of long-term objectives on which all could agree and on which people could work with a minimum of supervision and a maximum of responsibility.[3] They stated that to attain such a participative working environment requires special attention to the basic organizational structure of the company. At Hewlett-Packard, a product division was an integrated self-sustaining organization with a great deal of independence that performed in much the same way as the company had 22 years ago. The fundamental responsibilities of a division, extending worldwide, were to develop, manufacture, and market appropriate products. Acting much as an independent business, each division was responsible for its own accounting, personnel activities, quality assurance, and support of its products in the field. Coordination of the divisions was achieved primarily through the product groups. Group management had overall responsibility for the operations and financial performance of its divisions. Each group had a common sales force serving all of its product divisions. To keep an atmosphere that encouraged the making of problem-solving decisions as close as possible to the level where the problem occurred, HP has striven over the years to keep its basic business units—the product divisions—relatively small and well-defined.

Selected strategies and related policies

13 Hewlett-Packard's product-market strategy has concentrated on developing quality products, which make unique technological contributions and are so far advanced that customers are willing to pay premium prices. Products originally limited to electronic measuring instrument markets have expanded over the years to include computers and other technologically related fields. Customer service, both before and after the sale, has been given primary emphasis. Their financial strategy has been to use profits, employee stock purchases, and other internally generated funds to finance growth. They have avoided long-term debt and have resorted to short-term debt only when sales growth exceeded the return on net worth. Their growth strategy has been to attain a position of technological strength and leadership by continually developing innovative products and by attracting high caliber and creative people. Their motivational strategy has consisted of providing employees with the opportunity to share in the success of the company through high wages, profit-sharing, and stock-purchase plans. They have also provided job security by keeping fluctuations in production schedules to a minimum by avoiding consumer-type products and by not making any products exclusively for the government. Their managerial strategy has been to

[3] "Working Together: The Hewlett-Packard Organization," *Measure*, June 1978, pp. 10–11.

practice "management by objective" rather than management by directive;[4] they have used the corporate objectives to provide unity of purpose and have given employees the freedom to work toward these goals in ways they determine best for their own area of responsibility. The company has exercised its social responsibility by building plants and offices that are attractive and in harmony with the community, by helping to solve community problems, and by contributing both money and time to community projects.

14 **Division review.** A principal vehicle for effecting communication between corporate management and the basic operating units has been the division review conducted annually at almost every division and sales region. Described as the natural outgrowth of the personal interest and hands-on style so characteristic of HP, reviews by 1978 were covering a full range of business matters: financial performance for the past year; outlook for orders, shipments, and facilities for the next three years; detailed presentations on product development strategy and key programs; and a look at people management including training, recruiting, and affirmative action goals and results. A very broad cross section of division personnel as well as a visiting group of reviewers were involved in organizing, presenting, and participating in the reviews. The visiting reviewers generally included several members of the corporate executive committee, corporate staff heads such as personnel and controller, appropriate group and related division managers, and on occasion even outside directors.

15 **MBWA.** Another concept has received considerable attention at HP as "an extra step that HP managers needed to take in order to make the HP open-door policy truly effective." Developed by John Doyle, vice president, personnel, earlier in his career at HP, it has been termed "management by wandering around" or MBWA.[5] It has been described as friendly, unfocused, unscheduled, and—to any employee at their work with whom a wandering manager stops to chat—an invitation to repay the visit and walk through that open door whenever they choose. To encourage MBWA it has been the subject of management briefings and seminars. A two-part video program on MBWA has been taped and made available to all HP organizations. The three corporate personnel administrators have also begun to encourage it wherever they go on their liaison missions. One division general manager said of MBWA, "it's really a body chemistry kind of thing. You've got to really want to wander around and communicate at all levels." A manufacturing manager, talking about MBWA, indicated that "management by involvement" was more descriptive of the HP way than would be "man-

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[4] "Management by objective" is Hewlett-Packard's phrase for using corporate objectives primarily as a framework for coordination, decision making, and planning rather than for performance appraisal as in typical MBO programs.

[5] "What Is This Management by Wandering Around?" *Measure*, April 1978, pp. 8-11.

agement by overview." A sales region personnel manager, however, citing their communication problem as "a certain sense of isolation," noted that a "manager can't do much spontaneous wandering around" a sales territory.

Corporate organization and leadership transition, 1975–1978

16 The April 1975 restructuring which led to speculation on who would later be taking the corporate reins had three main parts: (1) it expanded the product groups from four (test and measurement, data products, medical equipment, and analytical instrumentation) to six (instruments, computer systems, components, medical, calculators, and analytical); (2) it added a new management level of top vice presidents; and (3) established an executive committee to oversee day-to-day operations of the company. The June 1978 corporate structure—except for some changes in the personnel holding various positions, a growing number of divisions within the product groups, and an increasing emphasis on computers and calculators—was basically the same structure as in 1975. (See Exhibits 6 and 7.) The company magazine *Measure*, introducing the 1978 organization, wrote that, "Except for an official transfer of titles and responsibilities plus a birthday celebration, you would hardly have known that HP made a rather significant change in its organizational character last month."[6] One day before his 65th birthday, Bill Hewlett's resignation as chief executive officer was made official in a brief announcement; thereupon, John Young, who in 1974 had been designated as "the leading contender," became CEO as well as president. Elevated to one of the then-new executive vice presidencies and to the board of directors in 1974, Young had fulfilled the numerous predictions made during the 1974–77 period by succeeding Bill Hewlett as president and chief operating officer in November 1977. Thus, by June 1978 John Young had completed a four-year preparation for the top spot wherein HP for the first time in its 39-year history would be managed by a team of managers developed within the organization rather than by its original founders.

17 Although Bill Hewlett, as chairman of the executive committee, and David Packard, as chairman of the board of directors, were still spending about half their time at HP, it was John Young who had been handed the tough task of taking Hewlett-Packard deeper and deeper into the unfriendly territory of computational technology.

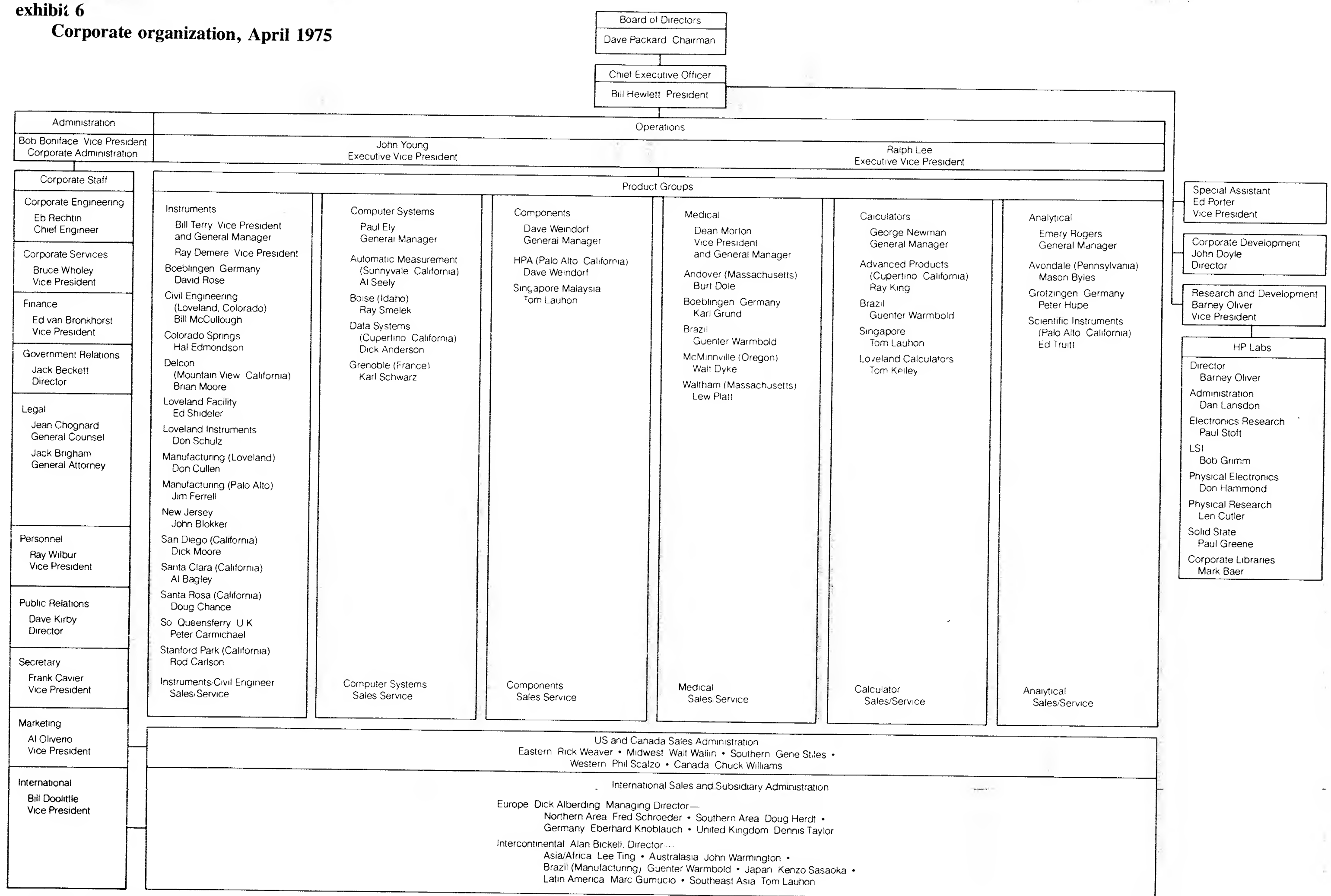
Computational technology

18 Hewlett-Packard has always been heavily engaged in electronic technology. Even as recently as 1977, a special section of their annual report indicated that nowhere else did technological innovation show more momentum than in electronics and its offspring, electronic computation. The environment, as pointed out by *Forbes*, is friendly indeed for HP in the field of measuring

[6] "The HP Organization: Reaching a Landmark Quietly," *Measure*, June 1978, p. 7.

exhibit 6

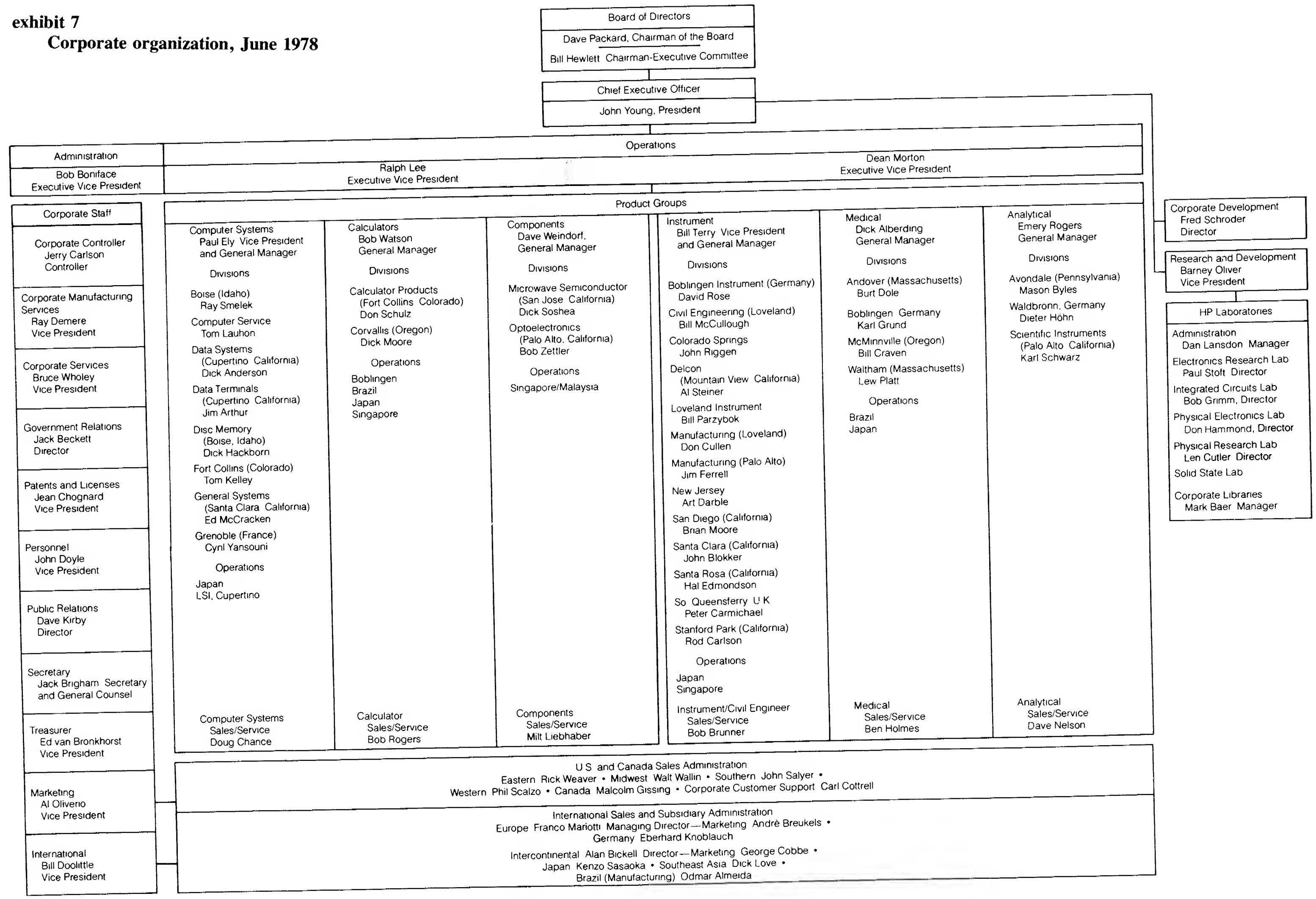
Corporate organization, April 1975



Source: "Working Together: The HP Organization," *Measure*, April–May 1975, pp. 16–17.

exhibit 7

Corporate organization, June 1978



instruments, where the company has made a big name for itself and the competition was comparable in size or more often specialized and smaller (e.g., Beckman, Tektronix, and Varian.)[7] But the instrument business had slowed in rate of growth; *Forbes* claimed the company, in order to keep its growth record intact, has had to move into a more competitive environment where the opposition is bigger and tougher (e.g., Digital Equipment, Texas Instruments, and IBM). See Exhibit 8 for asset size, debt position, and financial strength for typical instrument, electronic, and computer companies. See Exhibit 9 for key performance data for selected companies.

19 HP first became involved in the use of computational technology in the early 1960s when its engineers began to design instruments that could work together automatically in computer-controlled systems. The company carried the concept one step further in the mid 1960s with the introduction of a computer designed specifically to work with its instruments. The principal contribution offered by HP in that first computer was ruggedness—the ability to function outside a controlled environment, exposed to wide variations in temperature, humidity, and pressure. In subsequent years, HP products have been prominent in engineering and scientific applications, where there was a high premium on advanced instrumentation to solve complex problems of instrumentation and measurement, in widely varying environmental conditions.

20 More recently, the need for precise measurement and computation had become widespread in many different industries, businesses, and professions. Among the company's newest customers were those involved in business data processing. The first HP product aimed exclusively at this market was a hand-held calculator for financial analysis. At the other end of the size scale was the development in the early 1960s of HP's first minicomputer-based time-share system which found wide use in science and engineering, and was particularly well received in the educational market. The next generation of computers, introduced in the early 1970s, also found a ready market in the educational field because it could accommodate many different programs and computer languages. HP has steadily upgraded this computer as a result of applying the computer to HP's own business problems. This development has proved particularly useful to HP customers with similar worldwide manufacturing operations.

21 The relative success, however, of HP's excursions into hand-held calculators and minicomputers have been quite different. Erratic market conditions and heavy competition characterized both industry segments. There were marked differences, however, in the ability and willingness of the company to adapt and respond to these product/market changes.

22 **Hand-held calculators.** More widely known to college students and the general public than its broad line of basic products was the company's line of

[7] "Welcome to the Hot Seat."

exhibit 8
Selected financial position data on selected firms

Company	*Total assets 1978 ($ millions)*	*Total debt 1978 ($ millions)*	*Short-term debt as a percent of total investment capital 1978*	*Long-term debt as a percent of total investment capital 1978*	*Common equity as percent of total investment capital*	*Stock price as percent of book value P/S 9/22/78*
Beckman Instruments	277.0	79.3	17.7	17.8	64.4	244.4
Data General	322.1	59.6	0.0	25.4	74.6	349.2
Digital Equipment	1,436.5	119.2	3.4	10.6	86.1	237.0
Fairchild Camera	387.9	91.0	8.4	23.4	68.2	99.1
General Instrument	363.5	72.7	0.1	26.1	69.1	141.9
Hewlett-Packard	1,295.8	105.2	9.4	1.0	89.6	278.9
IBM	19,114.1	428.2	1.3	2.0	96.7	313.6
National Semiconductor	278.9	24.9	15.0	1.0	84.1	276.8
Raytheon	1,966.1	97.1	2.3	11.2	86.5	219.5
Texas Instruments	1,350.7	78.8	6.0	3.6	90.4	246.2
Tektronix	491.1	47.4	2.8	9.9	87.3	255.6
Varian Associates	312.6	62.7	13.7	14.5	71.8	86.2

Source: "A Significant Swing to Short-Term Debt," *Business Week*, October 16, 1978, pp. 122–36.

exhibit 9
Selected performance data on selected firms, 1974–1978

A. Sales growth (percent of change)

	1974–1975	*1975–1976*	*1976–1977*	*1977–1978**
Beckman Instruments	17%	6%	18%	18%
Data General	30	49	58	47
Digital Equipment	27	38	44	36
Fairchild Camera	−24	52	44	15
General Instrument	−11	24	8	8
Hewlett-Packard	11	13	22	24
IBM	14	13	11	13
National Semiconductor	10	38	19	28
Raytheon	16	10	14	16
Tektronix	24	9	24	32
Texas Instruments	−13	21	23	21
Varian Associates	6	10	3	14
Average	8.9%	23.6%	20.7%	22.7%

B. Net profit margin (percent)

	1974	*1975*	*1976*	*1977*	*1978**
Beckman Instruments	4%	4%	5%	6%	7%
Data General	12	12	12	11	11
Digital Equipment	11	9	10	10	10
Fairchild Camera	7	4	3	2	5
General Instrument	3	3	4	5	6
Hewlett-Packard	10	9	8	9	9
IBM	15	14	15	15	15
National Semiconductor	8	7	6	3	5
Raytheon	3	3	4	4	4
Tektronix	8	8	8	10	10
Texas Instruments	6	5	6	6	6
Varian Associates	3	3	3	4	3
Average	7.5%	6.8%	7.0%	7.1%	7.6%

C. Earnings on net worth (percent)

	1974	*1975*	*1976*	*1977*	*1978**
Beckman Instruments	8%	9%	10%	13%	15%
Data General	21	14	17	20	21
Digital Equipment	13	12	12	15	16
Fairchild Camera	17	6	7	6	13
General Instrument	7	7	9	12	14
Hewlett-Packard	18	15	13	15	15
IBM	18	17	19	21	21
National Semiconductor	35	25	20	10	17
Raytheon	14	15	16	18	20
Tektronix	12	13	13	16	17
Texas Instruments	17	11	15	16	16
Varian Associates	6	6	6	8	8
Average	15.5%	12.5%	13.1%	14.2%	16.1%

* Estimated by *Value Line Investment Survey* (Arnold Bernhard & Co., July 7, 1978), p. 187.

hand-held calculators. David Packard described HP's entry into this field in *The AMBA Executive* newsletter in September 1977: "Actually we got into the electronic calculator business by accident. We hadn't planned it at all."[8] In 1966 calculators were largely mechanical; a young man working for one of the calculator companies brought to HP a model for an electronic calculator. His own company was not interested in it because they didn't have the electronic capability. A HP team was put together and the first electronic calculator, with a great deal of power, was designed for the engineers at HP. It was, however, a large device about one foot square. Coincidentally, HP was also doing research on large-scale integrated circuits and on light-emitting diodes. Bill Hewlett realized that these technologies could be combined into a calculator, that these light-emitting diodes would make it possible to have a small readout, and that the result would be something that could be put into a pocket. A year later, the HP-35, the first hand-held calculator was introduced.

23 *Forbes* has reported that for a brief period, HP made itself the leader in the business and scientific hand-held calculator field, which in 1974 was estimated to have yielded roughly 30 percent of company profits.[9] Shortly after, HP's high-priced, high-quality calculators fell before the competition led by Texas Instruments. Rather than compete across the board, HP decided to remain in the specialized upper end of the market. In 1978 the division was reputed to be barely profitable, but with relatively stable sales.

24 **Minicomputers.** HP had become, by 1978, a well-integrated minicomputer manufacturer, competing with International Business Machines, Digital Equipment Corporation, and Data General. This business had long been characterized by high technological risk and erratic earnings. During the late 1960s, HP successfully directed sales efforts toward the educational, scientific, and engineering markets, where it was an established supplier of instruments. Subsequently, in entering the minicomputer market, the company chose to service the time-sharing sector, which fell apart in the 1970s, causing profit reversals.

25 Recently, however, the picture has improved and HP's electronic data processing product category has contributed over 40 percent of sales and almost the same proportion of profits, despite the drag from hand-held calculators. (See Exhibit 4.) HP has expanded its computer line into the area where others hold strong positions. HP's minicomputer line consisted basically of two products, one for business and one for scientific/technical use. Big customers often bought several systems at a time complete with peripherals-terminals, disc-drives, printers, and even instruments that could be attached. A single sale could easily exceed $1 million. The company was well aware of the dangers of its thrust into computers. Many big and smart companies had tried to take on IBM and lost. Hewlett-Packard has mounted

[8] "Hewlett-Packard Chairman Build Company by Design, Calculator by Chance," *AMBA Executive*, September 1977, pp. 1 ff.

[9] "Welcome to the Hot Seat."

its effort carefully. The division's domestic sales force has been almost doubled in the previous year to 500 people. The sales force has been split between business and engineering systems. Young has reportedly spent 10 percent of his time making sales presentations to customers' top management, since commitments in the $1 million range typically require board-of-directors' approval. The company has also limited its marketing efforts by foregoing well-covered markets like banks and insurance companies in favor of large manufacturing companies which could use systems that HP had developed initially for its own operations. Such firms could take a whole computer line from the technically slanted machines on the factory floor and near engineers' desks to business systems for payrolls and customer billing.

26 To effectively compete in minicomputers, the company has had to continue to be extremely innovative and creative, as well as efficient. The minicomputer environment was difficult, rapidly changing, and extremely competitive. In this market, Hewlett-Packard has started to kick at the shins of IBM, which was 15 times larger (see Exhibit 8). A June 1976 article in *Business Week* quoted a former HP marketing executive, then president of Tandem Computers, Inc., as saying, "The first rule of this business is not to compete with IBM."[10] And in October 1978, *Business Week* described an incredibly fast adjustment in (HP's) marketing strategy.[11] It also noted some rough spots in the road that HP had already traveled in the field of computational technology: (1) its early reliance on techniques that worked well with sales to engineers, but not with the applications-oriented commercial EDP customers; (2) the difficulty of selling the idea of distributed processing, a concept involving pushing data processing out of the central computer room, HP's primary strategic difference from IBM; (3) a period in 1973 when the HP 3000 had to be taken off the market and redesigned because its software was too powerful for the hardware; (4) the different requirements, buyer attributes, and decision processes that characterized the larger and more fragmented market of commercial systems; (5) the tough task of meeting systems repair and maintenance response standards set by the main-frame companies it was now up against; and (6) the hard push by its customers for more applications software that would allow customers to perform specific tasks. Included in the same *Business Week* article were two items that must have intrigued long-time observers of HP and the computer industry. The product manager for HP's new HP 3000, Series 33, noting how, since 1974, they had concentrated on expanded capability for the 3000 at about the original price, was quoted, "Now let's use the technology to drive down the price." *Business Week* also indicated that HP is likely "to see more competition in distributed processing, especially from IBM, which is expected to announce a powerful new series of low-cost main-frame computers this fall."

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[10] "Hewlett-Packard Takes on the Computer Giants," *Business Week*, June 7, 1976, pp. 91–92.

[11] "Hewlett-Packard Learns to Sell to Business Managers," *Business Week*, October 26, 1978, pp. 62B and 62G.

case 24

Carter Distribution Corporation (A)

1 The Carter Distribution Corporation (CDC) was created to support the marketing effort of its potential customers in all facets of physical distribution. It was formed as a major project of Carfam, Ltd., a family limited partnership initiated by Dr. and Mrs. Jeff Carter to finance such projects. The CDC, located in Little Rock, Arkansas, was developed as a total distribution center (TDC). The systems concept upon which a TDC is based was described by Carter in his *Managerial Logistics*. This book was one of the early leaders among the textbooks written in the newly evolving field of physical distribution. His concept of logistics requires examination of all the separate logistics activities (transportation, warehousing, inventory management, location of production and distribution points, order processing, materials handling, packaging, distribution, market forecasting, customer service, etc.) as interdependent parts of a whole logistics system. This system is subsequently viewed as one of several interdependent parts of the whole system of the firm. As Carter saw it, these components of logistics were not ends in themselves, but were the means to an end—the support of the marketing effort and ultimately the overall effectiveness of the organization.

2 Traditionally, most traffic management thinking has focused on the reduction of transportation costs through rate negotiation and selection of carriers. A less widely used concept, the "total cost approach," recognized that the transportation rate is only one element of the total logistics cost. Other costs included in this approach were interest, spoilage, and pilferage costs; cost of inventory; opportunity cost of money invested in inventory (both in warehouses and in transit); differential packaging costs of various transportation modes; and warehousing costs. In Carter's opinion, both of these methods were insufficient and reflected the failure of the transportation and warehouse industries to properly recognize their functions and their relationships to their customers. He believes that most of the firms in these industries do not understand or do not care to practice the approach he believes is needed—a combination of a systems viewpoint and customer orientation, frequently described as the "marketing concept."

3 Carter's approach was to go beyond the total cost approach to cost management and profit maximization concepts. This method involves examining all the additional costs and benefits which might result from activities such

This case was made possible through the cooperation of a firm which prefers to remain anonymous. It was prepared by Professors Roger M. Atherton and Dennis M. Crites of the University of Oklahoma.

as: (1) relocation of aspects of the production process; (2) faster or slower delivery times; and (3) shipping in bulk to different geographic locations, breaking bulk, and then performing additional activities, such as packaging, labeling, storing, assembling components, or whatever would decrease the total costs of producing and distributing the goods. The goal is to generate maximum profit by performing services which can be done less expensively after, or during, distribution. Other possibilities include the provision of meeting rooms; sales and display rooms; office space; quality control facilities; repair facilities; and anything else that would make the total distribution system more efficient, productive, and profitable. The key to this approach is the total distribution center. Such a center would perform all these kinds of services, rate investigations, and comparative economic studies to help determine the most profitable combination of distribution activities and modes.

4 A second, but equally important, key idea is the use of a different rate structure than is common in the ordinary warehouse. The standard contract provides for half-monthly or monthly rates depending upon when the goods are received. Carter had developed a rate structure of daily charges per pallet (container). According to Carter, this has a distinct competitive advantage in that current rate structures have built up over the years and, for individual shipments, frequently have very little relationship to the economics of the industry. He also contends that most shippers are warehousemen who have no idea as to their actual costs by specific items, weight, volume, or any other criteria. As a result, there is a considerable economic opportunity for those willing and able to see the overall transportation-marketing-organization system, provide an integrating service, and charge in relation to the actual costs. Carter is convinced that there are many opportunities going unexploited. This presented an opportunity for him to put together an organization of people who, believing as he does, could achieve both financial and personal rewards.

The transportation environment[1]

5 **Carriers.** Some companies acquire their own vehicles and provide their own transportation. These operations are referred to as private carriers. Most companies prefer to retain the services of common carriers, who provide transportation as for-hire carriers. The Interstate Commerce Commission (ICC) recognizes a number of types of common carriers by the type of commodity: general commodities, bulk commodities, frozen food, and a dozen or so more. Common carriers must have approval of a regulatory body to operate, publish their rates, offer certain types and qualities of

[1] This section has been largely derived from "Logistics Management and Operations," in *Marketing Strategy and Management* by J. A. Constantin, R. E. Evans, and M. L. Morris (Plano, Texas: Business Publications, 1976).

service, and so on. Railroads, airlines, and bus companies are examples of common carriers of both people and goods. Contract carriers offer a very specialized service and limit themselves to serving relatively few customers. They too must have authority to operate and cannot discriminate unduly among customers. Some automobile haulers and some freight airlines are examples of contract carriers. Freight forwarders are also a specialized type of carrier. Their main function is to consolidate shipments from many shippers and to forward them. They may use their own trucks or they may buy transportation from other common carriers. They too must have authority to operate. Exempt carriers are those which are exempt from economic regulation, although they are subject to safety regulation. Exempt carriers haul only commodities exempt from regulation, mainly certain kinds of agricultural products such as grain, cattle, eggs, and fish. There are also express companies and small parcel delivery companies. These carriers are limited to shipments which meet size and weight requirements and for which a premium is paid for quick delivery. Depending upon the company, the goods to be shipped, and the speed required, a company may use any or all of these types of carriers and forms of transportation. The mix will depend on the service available, costs, and the objectives and strategies of the firm.

6 **Rate structure.** Most items transported on common carriers move on a class rate determined for an individual shipment by a two-step process. The first step is to find the class into which a commodity has been placed. Classes are found in a book called a classification. The second step is to find the applicable tariff, a price list. The charges levied for a shipment for given distances are shown in the tariff for each of the major classes of goods. These class rates are uniform throughout the nation. Cost factors which affect the price are the density, the possibility of damage (for which the carrier may be liable), the loading characteristics, and other related considerations such as direction of travel, frequency of shipments, and regularity of shipments. A second type of rate is the exception rate.[2] It involves a modification of the classification governing the movement of the commodity between certain points. The exception means that those particular goods can be shipped at reduced cost, wherever the rate applies. The third type of rate is the commodity rate. Unlike class and exception rates, these rates are quoted directly in a tariff instead of through a classification. They apply to specified goods such as major commodity and raw materials. Both shippers and the ICC have agreed these deserve special considerations and reduced

[2] Rates are set by the carriers, but approval of the ICC (or state regulatory commission) is necessary. Carriers and shippers are constantly negotiating with one another for rate changes. Every year the ICC approves thousands of rate changes. Sometimes approval is granted without a hearing when there are no protests. The rates on which practically all goods move are far from being uniform. There are many unusual and seemingly inconsistent rates which have resulted from the interaction of supply and demand in different geographic areas. As a result, generalizations regarding the rate structure are virtually impossible.

rates. These rates are lower than the corresponding class and exception rates for goods of similar physical characteristics. A proportional rate is a part of a through rate. It is used in transit privileges, a service made available so that a shipper may stop his goods off at some point and later resume the shipment without losing the benefits of a through rate. There are many kinds of transit privileges. Grain may be stored in transit; metal may be fabricated in transit; cattle may be fed in transit; etc. There are many services available and carriers are generally responsive to requests for additional services if they can be done profitably. In order to prevent discrimination among persons, places, and commodities, special services must be published in a tariff and made available to everyone on the same terms.

The warehouse environment[3]

7 **Warehouses.** A private warehouse, like a private carrier, is for the use of its owner and is not open to the public. A general merchandise public warehouse handles almost anything that does not need special facilities or special care. Specialized warehouses are equipped for special purposes: grain elevators, bulk vegetable oil tanks, household goods, frozen foods, etc. There are two basic functions performed, the first is storage and the second is warehousing. Storage is providing space for goods to be placed until there is a need for them. Warehousing involves the actual movement of the goods. It includes breaking bulk shipments, mixing them, and forwarding them to other members of the distribution channel. Another set of functions involve serving as a sort of field office, order taker, disbursing agent, and inventory reporter. Some warehousemen have rooms for desk space for customer's salesmen as well as rooms in which customers can set up displays of merchandise.

8 **Rate structure.** Typically warehouses charge for their services in several categories: (1) so many cents per square foot for storage; (2) charges for handling in, handling out, and clerical tasks such as processing reports and freight bills; and (3) miscellaneous charges for such services as stenciling packages, repairing broken crates, and breaking bulk shipments into smaller shipments. Storage charges are frequently based on a two-week or monthly basis, and customers pay for the entire period even if their goods are in storage only for a fraction of the base period.

The opportunities

9 In the past 10–15 years, manufacturers, wholesalers, and retailers have begun to give a great deal of attention to physical distribution. This is partly

[3] This section has been largely derived from "Logistics Management and Operations."

due to the large amount of working capital that is tied up in inventory, which some studies report is about 30 percent of working capital for the average firm. The increased attention is also due to the large costs represented by physical distribution, which some studies have shown to be about 20 percent of sales, on the average. One marketing objective of almost every sales organization is to have goods available where and when the customer wants them. Different degrees of customer service will have different costs and different impacts on sales as well as profits. Through the impacts on other departments such as purchasing, production control, production, and finance, the logistics function can have substantial effects on both managerial efficiency and organizational effectiveness. The achievement of both customer service and cost management objectives, according to Carter, is the responsibility of the transportation and warehousing industries.

10 A study at a major midwestern university found that users of public warehouses had a generally low opinion of the typical public warehouseman. The users reported that the typical warehouseman: (1) is interested in selling space to his customers rather than in providing a distribution service, (2) does not understand how he can complement the user's distribution system, (3) is not creative in discovering innovative ways to reduce distribution costs, and (4) is not sufficiently concerned with the user's needs and wants. The reasons for these dissatisfactions are many. The major cause, however, is probably that the cost and efficiency of the warehouse operation is the typical warehouseman's primary objective. He only becomes concerned with his customer's goods when they arrive at his warehouse and loses interest when they leave it. He is operating the warehouse as a separate, or discrete, step in the distribution process. He may well be performing his specific task efficiently, but the opportunities for overall (total system) integration, synergy, and profit are being ignored.

CDC program and service[4]

11 CDC is a market-oriented company which has a broad view of its role in distribution. The firm has coined and adopted a term that describes its function: a marketing support system. Rather than viewing themselves in the business of providing warehousing, breaking bulk, and delivery service, CDC people see themselves in business to support the marketing effort of business firms through the provision of warehousing, breaking bulk, and delivery service. The company believes there is a subtle but profound difference between the two approaches. In the first method, attention of management is directed inward, focusing on the operation of the warehouse. In the second method, the attention of management is directed toward the customer, operating the warehouse is only one of several means to satisfying and serving the customer's needs.

[4] This section has been largely derived from private correspondence between Carter and the authors.

12 The CDC systems viewpoint and philosophy are: to help their customers fulfill profit and service objectives through finding the optimum combination of transportation, warehousing, and related costs and services. The achievement of an optimum combination might involve the following:

1. Reduced transportation costs through:
   a. Finding a more economical type of carrier.
   b. Recommending changes in processing or packing methods so that the customer's goods either:
      (1) Weigh less or are less bulky for shipping purposes.
      (2) Qualify for a lower rate classification.
   c. Recommending changes in *location* of certain processing operations so that the customer may benefit from a more favorable combination of production costs and processing-in-transit through-type freight rates.
   d. Consolidating the customer's goods with those of other customers to obtain benefit of larger-volume rates.
   e. Negotiating with carriers for a lower classification, type, or level of rate, sometimes on the basis of certain loading or other services the distribution center could perform, but that are less feasible for the customer or a regular public warehouse.
   f. Handling or facilitating the making of damage claims or the auditing of carrier's bills (to avoid overcharges).
2. Reduced warehousing and related handling costs by:
   a. Introducing a price system with a charge for storage for only the actual days stored (rather than the traditional monthly storage charge minimum).
   b. Suggesting changes in storage module sizes, packaging, packing, palletizing, containerizing, or other handling or storage features.
3. Improved or increased service and sales to their customers' customers by:
   a. Quicker delivery to their clients' customers.
   b. A lower market price and perhaps resultant sales their client could not otherwise obtain.
   c. Lower total inventories both for their client and for their client's customers.
   d. Provision of market information that might identify market opportunities for their clients.
4. Imaginative and continuing efforts to implement the two key CDC philosophies of *customer-orientation* and a *marketing support systems viewpoint* by:
   a. Recommending to customers or prospects the use of another city (or storage system) if CDC analysis indicated that other alternatives might be more favorable to the client.
   b. Investigating establishment of a CDC in another city if a present customer indicated a significant need for such services.

13 Outwardly, CDC might appear to be a public warehouse. The following examples of CDC accomplishments illustrate the integration and support activities which distinguish CDC from a traditional warehouse. It must, of course, be remembered that CDC is just starting up operations and that the opportunities to do all the things planned are limited.

CDC is having bulk shipments of some commodities, such as canned peas, delivered to its warehouse. It breaks the bulk, labels some of the cans with the private label of the supermarket and some with the customers label, and ships directly to the various locations as requested. Alternatively, the customer can ship to CDC and await specific orders, have CDC do the labeling, and have the goods delivered in far less time than a direct factory shipment at a much lower overall cost.

Certain items can be shipped much less expensively in a disassembled condition. CDC has made proposals to do the actual assembling for those customers who want to purchase the completed product. Items such as ball bearings, bicycles, swing sets, and furniture are examples.

CDC discovered that if orders of one customer were routed through a different warehouse in another city, they could be delivered three days sooner at a substantial saving. The customer accepted the proposal which meant an initial loss in sales to CDC, but since then the customer has been promoting CDC and has routed other business to CDC.

CDC recommended changes in inventory levels of several items. This cut down stock-outs on some items and reduced inventory levels on others. The effect was improved service on some and lower cost on others.

By working with a customer's order department a change in procedures of giving shipping orders was installed. Emergency deliveries were cut from two or three a week to one or two a month. These emergency deliveries cost the customer three or four times the cost of a normal delivery.

CDC negotiated rates with a carrier in behalf of a customer which made it possible for the customer to improve the efficiency of its distribution system.

CDC advised the customer of one of their customers on several matters which improved his receiving system and reduced stock-outs.

CDC has completed a study for one company which shows the effect of their innovations in pricing. It shows a 60 percent reduction in storage costs as a result of the daily pricing system. The tentative savings: $152,00 per year.

Resources

14 In addition to its unique approach to providing customers with a marketing support system, CDC has acquired a number of human, physical, and financial resources.

15 **Human.** Carter serves as chairman of the board. He has been at Templeton University since 1953, and has advanced to the rank of professor of marketing and transportation. Templeton is approximately 400 miles from Little Rock, so that Carter usually restricts his visits to weekends, school vacations, and summers. Carter is one of the most knowledgeable experts in the field of logistics management. He is also considered an expert in planning.

16 Richard Kirk was hired as president in March 1973. He had previously been a manager of physical distribution with a large national manufacturer of light machinery. He was a former student of Carter's. They had developed a close friendship over the years, both on an intellectual and common interest level as well as a personal and social level. Kirk had recently given up his job with the large company as too confining and no longer challenging to open up a bar near his hometown, when Carter asked him to join CDC. His initial responsibilities were in planning, in arranging equipment and space for the firm's warehousing needs and office, and in making a number of sales calls.

17 In mid-fall 1973, Kirk was joined by Mark Kallister, Carter's son-in-law, who was designated as vice president of CDC. Kallister, a regular army officer for seven years, had some army logistics experience and several recent BBA and MBA courses in physical distribution. It was while attending Templeton that Kallister met and married Carter's daughter. It was through both the courses he took and family discussions that he learned about Carter's concepts and ideas about logistics management. At his earliest opportunity, he resigned from the army to join CDC to help implement these ideas.

18 Arrangements had been made to obtain additional help, as required, from temporary-manpower employment services. In addition, Carter was considering the immediate employment of one other former student and the eventual employment of another son-in-law, as business developed. With access to both temporary help and managerial talent established, the personnel needs for the foreseeable future was deemed more than adequate.

19 **Physical.** For a warehouse and office, CDC was renting two bays (about 25,000 square feet) in a newly constructed, well-located, and well-equipped eight-bay warehouse building. They also held options to rent up to four of the remaining bays as needed. An adequate supply of racks, pallets, office materials, and other supplies had been purchased . A forklift truck had been leased. As the facilities actually rented were well above usage requirements, the facilities were considered quite satisfactory for the foreseeable future.

20 **Financial.** Since most of the equipment and facilities were leased or rented, there was little need for long-term capital. There were, however, a lot of expenses for salaries, rents, leases, publicity, entertaining, and other operating expenses which were not yet covered by sales revenues. Initial calculations were that they would need about $62,000 for equipment and start-up wages. At least one of the executives took a reduction in salary, and the difference was provided in stock. They estimated they would need $870,000

revenue per year, a rate which they believed could be attained in about two years. The seed money for these purposes was obtained from family members and the executives employed. There were neither bank debts nor outside stockholders.

Performance

21 In early spring 1974, they were still negotiating with several firms. Each of these could provide CDC with revenues of thousands of dollars a year. It was even conceivable that if their proposals were completely accepted, revenue well above $100,000 annually could be provided. Actual revenues were fluctuating between $100 and $200 a month. Only two small-volume customers were really using CDC services on a regularly established basis. Carter and his CDC associates had expected that it would take time for their sales efforts to pay off. Their prospective customers would often have to do a lot of checking and internal coordinating among departments before buying CDC's services. It was often difficult to determine whether to call upon the traffic manager, the purchasing manager, or the marketing manager. The CDC approach was substantially different from the past practices and traditions which have built up among traffic managers, shippers, warehouseman, and others involved in the distribution process. In many respects CDC was attempting to sell receiving, handling, storage, and related services of the same sort offered by most public warehouses. By selling these services as a marketing support system, CDC and its management team were offering a set of ideas and a way of doing business that they believed were uniquely valuable to their prospective customers.

case 25

Carter Distribution Corporation (B)

1 Dr. Jeff Carter, chairman of the board of the Carter Distribution Corporation, was understandably concerned. Earlier, he had carefully developed statements about his organization's purpose, mission, and objectives. Recognizing that these objectives were somewhat philosophical and were primarily reflections of his personal objectives for the organization, he decided to try to make them more operational. He requested his two key managers—and two other men who were to be considered for managerial positions—to provide him with their personal objectives, what they wanted to accomplish for themselves, along with some suggested operational statements to implement both the corporate and their personal objectives. He had asked for responses in a few weeks. Six months later he had received only one reply and that was from one of the candidates. Both of his key people were extremely busy helping to start up this new company. Resources were scarce; the break-even point had not yet been approached; and although interest was extremely high, only a few customers had made actual commitments. Carter was undecided whether to make a second request for the submission of these reports, with the more immediate and greater need for survival. He was aware of the crucial importance of executive morale ot his fledgling company, yet he also saw the possible negative impact on his relationships with his managers if he did nothing. He also knew the importance of concentrating the company's limited resources, both financial and managerial, on a restricted set of agreed-upon objectives. He also believed that unless the company's objectives were made more operational, it would be difficult to determine how effectively the organization was accomplishing its mission. Furthermore, unless the top managers felt involved in the determination of objectives and were committed to their accomplishment, the company would have little chance for success.

2 The Carter Distribution Corporation—designed "to support the marketing effort" of its potential customers "in all facets of physical distribution"—began its business development operations in the summer of 1973. Formed as a major project of Carfam, Ltd.—a family limited partnership initiated by Dr. and Mrs. Jeff Carter to finance such projects—the CDC, located in Little Rock, Arkansas, was to be developed as a total distribution center (TDC).

This case was made possible through the cooperation of a firm which prefers to remain anonymous. It was prepared by Professors Roger M. Atherton and Dennis M. Crites of the University of Oklahoma.

Background

3 Carter has been at Templeton University since 1953, and has progressed to the rank of professor of marketing and transportation. Almost from the time he arrived, he spoke with various professional, transportation, and industrial development groups of the need for a new concept in distribution centers. By the early 1960s, the systems concept upon which a total distribution center is based was described by Carter in his *Managerial Logistics*. This book was one of the early leaders among the textbooks written in the newly evolving field of physical distribution. The logistics concept he was recommending involved looking at all the separate logistics activities (transportation, warehousing, inventory management, location decisions, order processing, materials handling, packaging, distribution, customer service, etc.) as interdependent parts of a whole logistics system, which is only one of several interdependent parts of the whole system of the firm. As he saw it, these components of logistics were not ends in themselves, but were means to an end—the support of the marketing effort of the firm.

4 Previously, most traffic management thinking had focused on the reduction of transportation costs through rate negotiation and routing of freight. An interim concept, the "total cost approach," recognized that the transportation rate is only one element of the total logistics cost. Others include interest, spoilage, and pilferage costs; cost of inventory; opportunity cost of money invested in inventory (both in warehouses and in transit); differential packaging costs of various transportation modes; and warehousing costs. In Carter's opinion, the transportation and warehouse industries have not recognized their role; their relationships to their customers; and either do not understand, or do not care to practice, the marketing concept.

Total distribution center

5 Carter's approach was to go beyond the total cost approach to cost management and profit maximization concepts. This involves examining all the additional costs and benefits (increased sales and profits) which might result from relocation of aspects of the production process; changes in sales which might result from faster or slower delivery times; and shipping in bulk to different geographic locations, breaking bulk, and then performing additional activities, such as packaging, labeling, storing, assembling components, or whatever would decrease the total costs of producing and distributing the goods. The goal is to generate maximum profit by performing services which can be done less expensively after, or during, distribution. Other possibilities include the provision of meeting rooms; sales and display rooms; office space; quality control facilities; repair facilities; and anything else that would make the total transportation more efficient, productive, and profitable. The key to this approach is the total distribution center. Such a center would perform all these kinds of services, rate investigations, and

comparative economic studies to help determine the most profitable combination of activities and distribution modes.

6 A second, but equally important, key idea in this concept is a different rate structre than used in the ordinary warehouse. The standard contract provides for half-monthly or monthly rates depending upon whether the goods are received before or after the 15th. Carter had developed a rate structure of daily charges per pallet (container). According to Carter, this has a distinct competitive advantage in that current rate structures have built up over the years and, for individual shipments, frequently have very little relationship to the economics of the industry. He also contends that most shippers and warehousemen have no idea as to their actual costs for specific items or by weight, volume, or any other criteria. As a result, there is a considerable economic opportunity for those willing and able to see the overall transportation-marketing-organization system, provide an integrating service, and charge in relation to the actual costs. Carter was convinced that there were many opportunities going unexploited. He knew this presented an opportunity for him to put together an organization of people who, believing as he does, could achieve both financial and personal rewards.

Little Rock, Arkansas, location

7 During the 1965–1970 period, Dr. Carter and different associates worked on several studies, papers, and proposals concerned with transportation and economic development in the Arkansas River Basin, including the area around Little Rock, Arkansas. A number of executives and officials in Little Rock became especially interested in some of the concepts and findings involved. Some of these executives indicated to Dr. Carter that anyone who would organize a distribution center in Little Rock could be assured of very favorable support. The assurances included financing, physical facilities, and assistance in developing customers and patronage. A general study was made and Little Rock was found to be the least-cost location for an area extending from Chicago to New Orleans and Houston, and from Atlanta to Dallas. It is also a seaport in the nation's midsection (via the Mississippi River and the McClellan-Kerr Arkansas River navigation system). The port of Little Rock foreign trade zone is new and is capable of meeting a rapidly growing international market and of becoming a prime port and center for serving U.S. markets across the country. The free port law of Arkansas provides a strong incentive to base inventory and distribution as well as manufacturing activities in Arkansas.

From theory to practice

8 In late 1972 and early 1973, enthusiastic interest was being expressed by three or four former students, who held physical distribution or related positions, in joining Carter in initiating a total distribution center in Little

Rock. These were persons who both as students and in their careers had displayed superior insight and potential. In particular, they had shared with Carter, both socially and at professional meetings, many hours in discussion of the concepts, philosophies, and values necessary for optimum implementation of a total distribution system or center.

9 One of these men, Richard Kirk, had previously been in physical distribution management with a large company. Carter and Kirk started to work out capital needs. They concluded that they would need about $62,000 for equipment and start-up wages. They estimated they would need $870,000 revenue per year, a rate which they believed could be attained in about two years. If results were as predicted, they would make an attractive profit as well as respectable salaries for their executives. In March 1973, Carter asked Kirk to take charge of setting up the Little Rock operations. The company's Little Rock activities for the summer of 1973 were essentially a one-man operation. As president, Kirk spent most of his time planning, arranging equipment and space for the firm's warehousing needs and office, and making a number of sales calls. A policy had been adopted that CDC would try mainly to bring into Little Rock new distribution activities, e.g., by firms not previously distributing in that area. In other words, CDC was not trying to take business from Little Rock's currently operating warehouses, carriers, and related firms. To this end, Kirk made some sales trips to Chicago where he had a number of professional and business contacts in the physical distribution field.

10 In mid-fall, 1973, Kirk was joined by Mark Kallister, Carter's son-in-law, who was designated as vice president of CDC. Kallister, a regular army officer for seven years, had some army logistics experience and several recent BBA and MBA courses in physical distribution. Early planning, in which Kallister had participated, was that Kirk, with his lengthier time in industrial physical distribution, could train Kallister and help prepare him not only for his initial CDC–Little Rock responsibilities but also for starting up the next CDC–TDC venture, tentatively planned for Nashville, Tennessee. Kallister's work at first was to share in and to learn from Kirk more about the work and to handle some of the pickup, delivery, and related tasks for the first customers the firm acquired. He accompanied Kirk on some of the sales calls to Chicago and by the spring of 1974 was making sales calls on his own in Little Rock and Chicago. Kallister was becoming active with civic groups and individuals involved in developing the new port of Little Rock.

11 The company's policy on bringing new distribution activities to Little Rock, combined with the major impact of broad-scale physical distribution changes on the decision-making processes of potential clients, was leading to a long lag before sales development calls paid off. By summer of 1974, however, CDC was facing an odd situation. In terms of physical materials and revenue actually being handled in Little Rock, it was still a very small operation. The vice president was literally driving a delivery truck on the same day that he would make an evening presentation to some of the state's

leading bankers regarding economic development of the Little Rock area. The firm's proposed purpose, objectives, and resources had, however, stimulated such interest that the firm was going to have to decide within a very few weeks on which commitments to undertake from among several very promising projects being negotiated. In anticipation of further expansion, Carter was considering the immediate employment of a former student, Shawn Costello, who was employed as a sales manager at a major railroad. He would be asked to help obtain additional clients, negotiate with rail and other carriers, and work with the others in preparation for assuming responsibility for one of the developing projects. Another member of the Carter family, Bob Bentley, was also being considered, although nothing specific had been decided about the timing.

Managerial values

12 The managerial values of J. A. Carter were expressed in a memorandum prepared for CDC internal use and dated June 1973, as follows:

> While the mission of the organization and its objectives are stated in terms of the organization itself, they are directed toward the ultimate purpose: satisfaction to me. In this context, satisfaction has many dimensions, and my personal motives and objectives are hard to sort out. Even so, they are important because they determine the direction the organization will take. Among the forces underlying my personal objectives are:
>
> 1. To create a family organization to satisfy a parental need;
> 2. The desire to introduce some innovative concepts to satisfy a professional need; and,
> 3. The desire to build, to satisfy an entrepreneurial urge.
>
> The fact that neither profit nor creation of wealth is mentioned does not imply that they are ignored. If we are successful in operating the business to satisfy my wants, profit and capital accumulation will be the result. In fact the amount of profit and the rate of capital accumulation will be partial measures of success in each of the three areas mentioned.
>
> To satisfy a parental need
>
> By means of a family organization, several parental needs will be met. First, security for each of our children, especially our daughters, is one of four significant objectives. To this end future investments for them will be made in their family-oriented objectives is to provide our sons, daughters, and their spouses with the opportunity for employment in a family enterprise and to allow them to earn further ownership via stock options, bonus, profit sharing, and the like. The ownership thus earned will be for performance as managers and thus ownership will be vested in the manager.
>
> The foremost among the possible dangers is associated with sibling primacy—who runs what. Another recognized danger centers on potential problems related to productivity and compensation. Externally, a potential problem arises from the effect of family participation on executives, em-

ployees, and investors. While there are very real dangers, I think the organization plan will minimize them.

To satisfy a professional need

There are many gaps in the field of physical distribution because others have not seen them or have not had the interest to seek to close them. Our organization will seek to close those gaps where analysis discloses potential profits consonant with risk. This need establishes an innovative direction for the organization. As a result, managers will be expected to search out new opportunities for development within the framework of our mission statement which gives direction to the firm.

Despite the importance I place on the mission statement as a devise to keep us from going every which way, I do not consider it to be inviolate. As strongly as I fell about the firm as a vehicle to bring me satisfaction, I must also allow others (executives, family and nonfamily colleagues) the same privilege. Accordingly, while we will not lightly go beyond it, it may be modified to embrace some area particularly appealing to key members of the organization. To do so is entirely consonant with my philosophy of seeking out opportunities and problems.

To satisfy an entrepreneurial urge

I am interested in building an effective and efficient enterprise for its own sake. It will be a source of personal enjoyment and satisfaction to participate in the development of an organization dedicated to searching out opportunities and exploiting them. Again, I mention the framework established by the mission statement, and repeat that it is the unifying force which gives direction. It is subject to reevaluation and possible rewriting from time to time. In fact, periodically, key people directing the firm will be asked to consider its continued suitability.

Purpose and mission

13 A 10-page description explaining several other aspects of CDC thinking was prepared in July 1973. Although prepared primarily for internal guidance this description was also intended for selected use in the company's selling and promotional efforts and began with the following paragraphs:

Purpose: To support the marketing effort of our customers everywhere especially those customers serving the more critical areas of public need—through innovative strategic, managerial, and operational leadership and communication in all facets of physical distribution. By so doing, we will seek to improve the effectiveness of the distribution system and the efficiency of the several distribution processes.

Mission: To be in all facets of physical distribution necessary to fulfill our purpose and meet market requirements.

Implications: Our purpose establishes the character of our organization; our mission establishes its direction; together they have several implications. First, with a commitment to support the marketing efforts of our customers, our function transcends that of a public warehouse, a distribution warehouse, a distributor, or what have you. It means that our concern

is not only with the processes of physical distribution—warehousing, transportation, and the like—but also with the function of the distribution system in facilitating the marketing effort. It further means that we do not concern ourselves with the efficiency of operation of any one element of the system, but we are concerned with the effectiveness of the system first and the efficiency of the parts second. It further means that we are as concerned with conceptual matters to at least the extent of our concern with operational matters.

Second, when we refer to our customers everywhere, we identify our areas of operation: local and regional; regional and national; national and international. By that reference we imply that our area of operation is not to be confined to Little Rock, Arkansas. Not implied, but certainly meant is that our choice of future locations will be powerfully influenced by the needs of our customers in a given location.

Third, our special reference to customers serving the more critical areas of public need establishes a direction for our initial marketing effort. This is, of course, only one of several criteria which include opportunity and profitability. Also, of course, the critical areas of public need which offer opportunity for service to the public and profit and, in general, entrepreneurial opportunity, are the food industry, hospitals in cooperative effort including food, linens, supplies, the petroleum industry (energy), and the housing industry. Accordingly, our first efforts will be directed to anything within reason which will come along and will yield us revenue to help us stay alive. When we are able to pick and choose, our efforts will go toward canned foods; building materials and household items; oils and greases; and hospital supplies.

Fourth, our commitment to innovative leadership in strategic, managerial, and operational matters has several implications. For our organization, it implies that we must have a complete dedication to developing and/or applying better ways of doing things. It implies that we must be prepared to seek out key managers and employees who have a particular managerial philosophy. It further means that our organizational structure, our systems of rewards, and our methods of control must be "different."

Further, as we emphasize strategic, managerial, and operational leadership, we commit ourselves to a certain relationship to our customers and to our industry. For one thing, we may—and will—help our customers devise strategies to help them attain their objectives which may cause us a loss in revenue. Or we may devise managerial and operational approaches for them which have the same result. The short-term effect may be a loss in revenue for us, but we will make it up in the long run either by receiving more business or in the satisfaction of having done our job well.

Fifth, we commit ourselves to the improvement of the effectiveness of the distribution system as a whole and the efficiency of its several parts. While not stated, this implies to us that we are concerned with the total logistics environment as it affects our customers directly and as it affects the economic development of the regions we are a part of. Thus, we accept as a challenge and a commitment the role of helping improve the total logistics environment to the end of making an area a more attractive place for job creation. (And, at the same time creating a greater demand for our services.)

> Sixth, our mission statement establishes our direction and thus indicates the general areas we will be searching to discover opportunities to exploit and problems to solve. It is not a confining statement, only a guiding one. First, our purposes and missions are subject to study and restatement periodically; so they are not ever to be considered final. Second, while we will not actively seek opportunities outside our field, as we run across them or as they are brought to us, we will ask ourselves if it is time to reevaluate our mission. Then, if appropriate, we will evaluate the opportunity.

14 The 10-page description continued with a listing and explanation of the company's 15 major objectives, from which the following were selected for heaviest emphasis in its promotional literature:

Objectives

15 The major objectives and their implications are as follows:

1. *Objective*: To create and retain satisfied and profitable customers.
   Implications: This requires continuing analyses to determine customer wants and needs, to develop new concepts of service, and to increase our productivity.
2. *Objective*: To be an agent of effective change in our own spheres of operation.
   Implications: This objective will necessarily shape our philosophy of operation, have an impact upon our organizational structure, and influence our relationships with our employees and customers.
3. *Objective*: To provide leadership in improving the effectiveness and efficiency of the international flow of goods, services, and ideas.
   Implications: Our activities and expertise will be directed equally to the support of international and domestic marketing efforts of our customers. Our own marketing efforts will be directed toward foreign customers as well as domestic; so our firm must improve its understanding of cultural and economic practices of the major trading nations.
4. *Objective*: To be a marketing support system and consider ourselves as extensions of our customers' managerial group.
   Implications: We will be in effect an extension of our customer's distribution system. This also implies that so far as possible, our goals and strategies should mesh with those of our customers.

16 In September 1973, Carter decided that the objectives needed to be made somewhat more specific and operational. He also wanted to modify them to include the personal objectives of the present and anticipated members of the management team. On several previous occasions the opinions and contributions of these prospective managers had also been solicited in anticipation of their joining as soon as the expansion was warranted. See Exhibit 1 for a condensed copy of the letter Carter sent asking them for help.

exhibit 1

Memo

To: Richard, Mark, Shawn, Bob

From: Jeff

Date: 9-14-74

Subject: Objectives

All of you have copies of our objectives. Clearly, they are mostly identifying the general direction—even though much more specifically than the purpose and mission statements. As such, they are mostly philosophical statements. Eventually, I will get around to writing them in an operational way.

Will you give them some study and suggest operational statements?

By and large, those objectives, purpose and mission, reflect *me*, my philosophies, aspirations, etc. I know that generally we all adhere to the same general notions. Nevertheless, if we are to accomplish what we say we are going to accomplish in those statements, we need more than me, my notions, and aspirations. We *need* yours.

Specifically we comment on our managers and things being different. So far as I can tell, most of the managers we educate in our colleges of business are not the type that modern business needs. Certainly, they are not the type that we need. Strike that—they are not the type that we are going to have. Our people will be as at home in staff work of planning as they are in the line work of managing—at least the line managers will. There will be none of this horse manure that "I've got to run my department and haven't got time for planning." I do not have time for that type of person. Line managers *must* work for the organization first and help determine organization objectives, plans, and policies as well as the strategic aspects of departmental policies. A system cannot function effectively otherwise.

There will be none of the stuff such as we heard from one of our potential customers. Richard told the guy that he was using off-size pallets which created a problem. His response in effect was that he knew it, that the decision on pallets was the manufacturing department, and that might as well be another company.

The other side: While our line managers *must* engage in these things for the organization as a whole, the reverse does not necessarily hold true. Our staff people need not be line people. All of this implies certain types of people with certain types of personal objectives.

Over the course of the next several weeks, will each of you give some thought to your own objectives, what you want to accomplish for *you*, write them up and send them to me?

One of these days, we will all talk about these things and modify our overall objectives to see that they somehow or other reflect your aspirations. Since our objectives reflect *me*, they are in my opinion incomplete. Mine must be modified somewhat to reflect *us*, not *me*. I consider this to be one of the most important things we will do. Each of us has different satisfactions to attain, and all of those satisfactions must be *considered*. If we were not generally in agreement, we would not have the association that we have; but we have to consider all of us.

(The rest of the letter went on to describe progress with several different prospective customers and the fact that at this point "We don't have a customer yet.")

17 In October, Costello forwarded his response after sitting on it for a month. The other managers had not responded as of early spring, 1974. Both of the managers already employed had been working long hours. Even their social contacts were directed at potential customers, and they were constantly in touch with one another by telephone at all hours of the day and night. The company's scarce resources needed constant monitoring and careful attention. The break-even point had not been reached, but progress toward it was encouraging. New prospects and new opportunities were continuously coming to the attention of management. Although few organizations had made actual commitments, the reason appeared to be that it took time to convince typical traffic managers of the advantages. There was always a potential for increased customer service; there usually, but not always, was a potential for increased profit. It subsequently took even more time for the traffic managers to convince their own organization's higher management of the potential gain of taking the systems view of logistics management. There were some disappointments along the way, but enough companies appeared to recognize the potential benefits to make the TDC in Little Rock economically feasible. It also appeared that the same idea might work in other locations and management earnestly began to explore additional opportunities.

18 However, Carter knew that one basis for selection of projects would be how well they suited the company's objectives. Since these objectives were incomplete, it would be more difficult to analyze alternatives. He also realized that the way he reacted to this dilemma would have a lot of influence on his relationships with his top managers. If he forced them to respond, he might detract their efforts from promotion, customer service, or other urgent operating matters. He might also reduce their feelings of independence, entrepreneurship, flexibility, or innovation. Morale of these key executives was an important consideration, and to require them to do this might lessen their involvement and commitment. However, without operational targets, it would be difficult for Carter to determine the progress the company was making, particularly since financial results were secondary to personal objectives. Carter was also concerned because open communications among the management team are essential to his philosophy of doing business, yet in this important area, the communications appeared to be mostly one way. Due to the impending need for major project decisions, he would have to do something soon to obtain their personal objectives and operational statements in time for use in making these key decisions.

Appendix: Objectives of the Carter Distribution Corporation

Rather than develop a free-standing creed for our company, we state our beliefs about several things and then identify our objectives in light of those beliefs. Naturally, our creed, purpose, and mission are interdependent. It is probably immaterial whether our beliefs shaped our purpose—but they

probably did—or whether our purpose shaped our beliefs—as they probably did.

1. *Belief:* Effective and efficient support of our customers' marketing effort depends upon our determining and satisfying their needs and our making a profit in the process.
   Objective: To create and retain satisfied and profitable customers.
   Implications: This requires that key managers be equally concerned with (1) analyses leading to the development of objectives, plans, strategies, and policies for the effectiveness of our organization as a whole, and (2) the rationalization process of using modern methods to improve the efficiency of our operation. Specifically, it includes market analyses to determine what our customers want and need or should want and need. Also, it includes keeping an eye on the future to discover opportunities and problems. In addition, it means the development of new concepts of service and methods of operation to increase our productivity.

   Further, it means we must know which customers are unprofitable, develop ways of making them profitable, or barring that, drop them. Too, it means that we recognize that an unprofitable customer places a burden on our ability to satisfy others.

   Overall, it means that we are a marketing-oriented company dedicated to serving our customers well and making a profit.
2. *Belief:* We believe that change is the only constant in the economic environment.
   Objective: To be an agent of effective change in our spheres of operation.
   Implications: This objective will necessarily shape our philosophy of operation, have an impact upon our organizational structure, and affect our relationships with our employees and customers.
3. *Belief:* We believe that we can and should actively design our own future rather than passively adapt to change to the extent that we make happen those things we want to have happen—for ourselves and our customers.
   Objective: Determine to the best of our ability what (1) is likely to happen in the future, and (2) what we want to have happen and design a program to accommodate our conclusions.
   Implications: This means that we keep the past in perspective for the lessons it taught, recognize that the present is only a transitory path to the future, and know that our future is what we make it—and that it will soon be our past. All of which implies that we must devote a great deal of attention to planning.
4. *Belief*: In the future our country must be more involved in international intercourse than at any time in the past, and that it is now in, or approaching, the resource posture such great trading nations as the

Netherlands, Great Britain, and more recently Japan have had for decades.

Objective: To provide leadership in improving the effectiveness and efficiency of the international flow of goods, services, and ideas.

Implications: Our activities and expertise will be directed equally to the support of the international and domestic marketing efforts of our customers. This implies that our expansion program will include opening distribution centers in foreign countries, probably starting in Canada and Latin America.

5. *Belief*: Effective international intercourse demands that our nation buy abroad as well as sell abroad.
   Objective: To support the marketing effort of foreign firms marketing here with the same diligence we apply to domestic firms marketing abroad.
   Implications: The nationality of our customers is important in only one broad way: we must improve our understanding of the cultural and economic practices of foreign people in order to better serve their needs here and American needs abroad.
6. *Belief*: Our greatest potential for service to the public at large is in those areas of basic human needs: food, health, shelter, and energy.
   Objective: Direct our efforts primarily to the canned food industries, those serving housing, hospitals, and petroleum items.
   Implications: These industries provide a direction for our first marketing efforts. It may become necessary to broaden the normally viewed functions of distribution to include canning and packaging of such items as oil, detergents, and the like which are received in bulk.
7. *Belief*: There are dislocations and dysfunctions in the logistics environments which militate against both the economic flow of goods and the economic development of regions, and thus restrict markets.
   Objective: To improve the logistics environment in the geographic areas in which we are located.
   Implications: We will have to become involved in restructuring rates and practices of carriers and warehousemen and improving service to small towns. This is in our interest as well as in the interest of our community and region.
8. *Belief:* The economic development of the regions where we are located is enhanced by bringing new firms to the region.
   Objective: To attract as customers those firms not now using Little Rock or any other city we locate in as a distribution point.
   Implication: Our efforts will not be directed toward attracting customers away from public warehouses in our area. It (1) makes no net contribution to the area, and (2) it is probably more difficult than attracting new customers.
9. *Belief:* The economic development of our area benefits us.

Objective: Work with other agencies and companies in a leadership position to further economic development.

Implications: We support these efforts now with our expertise. As we become capable of doing so, we provide financial support. We will join with carriers, other warehousemen, bankers, civic groups in joint efforts. Specifically, in Little Rock we will participate in furthering the development of the foreign trade zone and the port.

10. *Belief*: A total distribution complex is necessary to provide a complete support system for international and domestic marketing efforts.

    Objective: To create a distribution complex consisting of a distribution center, intermodal transfer facilities, consolidated terminal operations, satellite terminal facilities in small towns, and other facilities and services.

    Implications: The distribution center is only one facet of a total complex. Its strategies must be directed toward its ultimate role as nucleus of the complex.

11. *Belief*: Transportation and warehousing companies as a group have not been as diligent in supporting the marketing effort of their customers as we think is desirable and profitable.

    Objective: To innovate in conceptual, managerial, and operating areas to improve the effectiveness of the physical distribution system, the efficiency of the parts of the system, and thus reduce cost and/or improve service to users.

    Implications: The discovery process has been largely ignored by distribution people. We have adopted as one of our major functions the discovery of problems and opportunities of today and of the future in order to (1) identify what we want to have happen, and (2) develop plans to make happen what we want to have happen.

13. *Belief*: Increases in productivity should be shared with employees and customers.

    Objective: To pass along to our employees and customers a portion of improvements in productivity through higher wages, better service, lower prices, etc.

    Implications: Our marketing orientation recognizes that our employees in contact with our customers, those performing tasks for them, and our managers developing concepts of service all convert the hollow words *customer service* into a real-life working concept. One of the ingredients of customer service is "good service at low cost." As our productivity increases our employees and customers are partners in our program of advancement of the industry. We will become leaders in the industry in all matters including price. Some will refer to us as price cutters, we will be productivity leaders.

14. *Belief*: Small towns have notoriously bad service from transportation and distribution companies despite their vitality and growth rates.

Objective: To bring good distribution service to the small towns of the areas where we are located.
Implications: Many are unaware of the growth rates of small towns and of the opportunities they present for distribution companies. We see opportunities for service and profit—just as clearly as we see the problems involved.

15. *Belief*: We have a very strong belief in the competitive system, the profit motive, and the many dimensions of satisfaction for entrepreneurs and managers.
Objective: To manage our business in such a way that we advance the industry through our innovative activities, make a substantial profit from our efforts, and reap the many personal intangible rewards from our activities.
Implications: We will not meet competition, we will make it. We seek our rewards from profits and from the professional satisfaction of doing a job well. Our allusions to public service have not been solely from an altruistic posture. We merely believe that if we operate from the bases discussed we will have built a better mousetrap and will catch more mice. Perhaps our major altruism stems from our patriotic thought that if we render better service to our customers and our community we will be privileged to pay more income taxes in the highest corporate bracket and progressively higher personal brackets!

case 26

Carter Distribution Corporation (C)

Carter's questions

1 In midspring 1974, Dr. Jeff Carter, chairman of the board for the Carter Distribution Corporation (CDC), and a professor of marketing and transportation at Templeton University, was musing with mixed emotions over a letter from Shawn Costello, one of his former students. Shawn had been an outstanding student in several of Carter's classes five years earlier.

2 In class and in several lively social conversations both then and during Shawn's successful business career since, Carter and Shawn had discussed the rich opportunities for major improvements in physical distribution programs. Indeed, the fledgling one-year-old CDC—a different total distribution center—was partly an outgrowth of many similar discussions Carter had enjoyed during his professional career. The letter now in his hands included several of Shawn's usual stimulating ideas; more importantly, however, it reiterated another topic Shawn and Carter had discussed two or three times during the last several months—Shawn's abilities and interest in joining CDC when the time was appropriate. Shawn's abilities and interest were a welcome part of the careful planning Carter had done in preparing for and initiating CDC. But he wondered, had the appropriate time arrived? Might it possibly never arrive?

3 The fledgling CDC effort had been greeted with enthusiastic interest by many of its prospective customers—and new interest and opportunities were appearing almost daily. Over eight months of sales development efforts, however; had produced very, very meager sales revenue. Carter and his CDC associates had expected that it would take time for their sales efforts to pay off. Their prospective customers would often have to do a lot of checking and coordinating before buying CDC's services. Were the CDC ideas and services, however, really harder to sell (and to buy) than they had believed? Or had there been some weaknesses in the CDC selling efforts? Did Shawn have some strengths and experience that might be just what CDC needed at this time? These were among the questions that Carter knew he would have to answer in his own mind and discuss frankly with Shawn—before inviting Shawn to share CDC's odd situation: a rapidly growing crop but some doubts about harvesting methods and results.

This case was made possible through the cooperation of a firm which prefers to remain anonymous. It was prepared by Professors Roger M. Atherton and Dennis M. Crites of the University of Oklahoma.

The background

4 The Carter Distribution Corporation—designed "to support the marketing effort" of its potential customers "in all facets of physical distribution" began its business development operations in the summer of 1973. (See Exhibit 1.) Formed as a major project of Carfam, Ltd.—a family corporation

exhibit 1
Purpose and mission

Purpose: To support the marketing effort of our customers everywhere through innovative strategic, managerial, and operational leadership and communication in all facets of physical distribution; to improve the effectiveness of the distribution system and the efficiency of the several distribution processes.

Mission: To be in all facets of physical distribution necessary to fulfill our purpose and meet market requirements.

Implications: Our purpose establishes the character of our company; our mission establishes its direction; together they have several implications.

First, with a commitment to support the marketing efforts of our customers, our function transcends that of a public warehouse, distribution warehouse, or what have you. It means that our concern is not only with the processes of distribution—transportation, warehousing, etc.—but also with the function of the distribution system in facilitating the marketing effort.

Second, by reference to our customers everywhere we identify our areas of operation as national and international; regional and national; and local and regional.

Third, our commitment to innovative leadership implies our complete dedication to developing and/or applying better ways of doing things. Also, it identifies our own orientation to our customers in helping them devise distribution strategies to meet their objectives.

Objectives

Rather than develop a free-standing creed or statement of beliefs, we have stated our beliefs about several things and identified objectives to sustain those beliefs. Among our stated objectives are the following:

1. Belief: Effective and efficient support of our customers' marketing effort depends upon our determining and satisfying their needs and our making a profit in the process.

Objective: To create and retain satisfied and profitable customers.

Implications: This requires continuing analyses to determine customer wants and needs, to develop new concepts of service, and to increase our productivity.

2. Belief: Change is the only constant in the economic environment.

Objective: To be an agent of effective change in our own spheres of operation.

Implications: This objective will necessarily shape our philosophy of operation, have an impact upon our organizational structure, and influence our relationships with our employees and customers.

3. Belief: Our country in the future must be more involved in international intercourse than at any time in the past.

Objective: To provide leadership in improving the effectiveness and efficiency of the international flow of goods, services, and ideas.

Implications: Our activities and expertise will be directed equally to the support of international and domestic marketing efforts of our customers. Our own marketing efforts will be directed toward foreign customers as well as domestic; so our firm must improve its understanding of cultural and economic practices of the peoples of the major trading nations.

exhibit 1 ***(continued)***

4. Belief: Transportation and warehousing companies have not been as diligent in supporting the marketing effort of their customers as we think is desirable and profitable.

Objective: To be a marketing support system and consider ourselves as extensions of our customers' managerial group.

Implications: We will be in effect an extension of our customers' distribution systems. This also implies that so far as possible, our goals and strategies should mesh with those of our customers.

Note: Our full statement of purpose, mission, and objectives is available upon request.

Our perspective of the distribution system

An anecdote will help explain our role in distribution. An observer asked one worker what his job was. "I'm mixing mortar" was the answer. A second responded that he was installing glass. The third, obviously a bricklayer, said, "I'm building a cathedral."

Many view transportation, warehousing, management of inventory, and other elements of the distribution system as the first two workers viewed their jobs. CDC has a broader view both of the system and of its role in the system. More so than even the bricklayer! As we see it, the role of physical distribution is to support the marketing effort of a company. So, we say that we are a marketing support system, working at the strategic and managerial and operational levels of management to help our customers attain their objectives effectively and efficiently.

Here are some of the things we do at the strategic level:

Help our customers attain THEIR international and domestic marketing objectives via physical distribution.

In effect become a part of our customers' managerial staff: recommend means of carrying out customers' policies; provide our customers with distribution information.

Help our customers identify effective channels of distribution and develop means for going through that channel.

Here are some of the things we do at the managerial and operational levels:

Assure precise and correct shipments of goods.

Provide dependable on-time shipments to meet the goals of our customers.

Maintain consistent high-quality service performance.

Communicate!

We are a marketing support system; on behalf of our customers we examine all aspects of the physical distribution environment; we assume each step along the channel whether it is transportation, warehousing, or other, to be a variable which is subject to adjustment to meet our customers' objectives; we assume each of the processes to be parts of a continuous system of distribution which exists to attain the objectives of users.

Why Little Rock!

The concept of physical distribution starts and ends with the geographic market, customer demand, and marketing effort. For the past decade, markets in this country have been served primarily from five strategic distribution points, northern New Jersey, Chicago, Atlanta, Dallas and Los Angeles. These locations skim the cream, however; markets are demanding much more than these distribution points can pro-

exhibit 1 ***(concluded)***

vide. There are several potential prime distribution locations that can meet today's market demand for improved physical distribution activity and scope—Little Rock is one such place and it is ready to go.

Little Rock is a 360-degree distribution center—cost and service allows deep penetration into existing distribution areas. Congestion in the larger cities will allow us to take an even greater share of the once impregnable service areas of the Big 5 locations.

Little Rock is a seaport in the nation's midsection. The foreign trade zone here is less than one year old and is capable of meeting a rapidly growing international market and serve as a prime port and center for serving U.S. markets across the country. The free port law of Arkansas provides a strong incentive to base inventory and distribution as well as manufacturing activities in Arkansas.

Little Rock—it is national and international; regional and national; and local and regional—that is why we are here.

Who we are

(Note: For mailing, this "Who we are" column was the back of a folded-letter-size mailer and the "Presenting . . ." column the cover. Under who we are was a brief paragraph describing each of the principal officers of the firm, Carter, Kirk, and Kallister. The descriptions stressed both the academic and real-world backgrounds and such points as "he has long recognized the need to improve physical distribution through stronger marketing implication in distribution systems," and "a strong believer in total customer service.")

Presenting . . .

CDC

THE CARTER
DISTRIBUTION CORPORATION

MARKETING SUPPORT SYSTEMS

initiated by Dr. and Mrs. Jeff A. Carter to finance such projects—the CDC, located in Little Rock, Arkansas, was to be developed as a different total distribution center (TDC).

5 The development of a TDC was an indirect culmination of a body of concepts developed by Carter through more than 20 years of professional study and research. His principal teaching and writing work was in the area of physical distribution and logistics. This expertise—combined with a strong background in the field of industries and resources—led industrial development agencies in several states, including Arkansas, to retain him for studies and consultation. A recurring theme, not only in courses being taught but in speeches he gave and in many of his studies, was the need for a total distribution center viewpoint. Some of the Arkansas industrial development people with whom Carter worked had on two or three occasions during the late 60s and early 70s broached the subject of Carter's setting up a TDC in Arkansas, an area several hundred miles from Carter's home and work at Templeton.

6 In late 1972 and early 1973, another set of circumstances led Carter to analyze more carefully the initiation of a total distribution center in Little Rock. Enthusiastic interest was being expressed by three or four former students, now holding physical distribution or related positions, in joining Carter in such a venture. These were persons who both as students and in their careers had displayed superior insight and potential. In particular, they had all shared with Carter socially and at professional meetings many hours in discussion of the concepts, philosophies, and values necessary to optimum implementation of a total distribution system or center. The sale of some stocks and other investments also provided Carter and Carfam, Ltd. with the funds which would be needed. Consequently, detailed planning and analysis which had begun in late 1972 resulted near the end of March 1973 in a decision to start operation of a Little Rock TDC that summer. (See Appendix for fuller details.)

Initial operations

7 The CDC's Little Rock activities for the summer of 1973 were essentially a one-man operation. The president, Richard Kirk, previously in physical distribution management with a national manufacturer of machinery and a former student of Carter's—spent most of his time in planning, arranging equipment and space for the firm's warehousing needs and office, and in the making of a number of sales calls. A policy had been adopted that CDC would try mainly to bring into Little Rock new distribution activities, e.g., by firms not previously distributing in that area. In other words, CDC was not trying to take business from Little Rock's currently operating warehouses, carriers, and related firms. To this end, Richard made some sales trips to Chicago where he had a number of professional and business contacts in the physical distribution field.

8 In mid-fall, 1973, Richard was joined by Mark Kallister, Carter's son-in-law and also a former student, who was designated as vice president of CDC. Mark, a regular army officer for seven years, had some army logistics experience and several recent BBA and MBA courses in physical distribution. CARFAM planning, in which Mark had participated, was that Richard, with his lengthier time in industrial physical distribution, could train Mark and help prepare him not only for his initial CDC–Little Rock responsibilities but for starting up the next CDC-TDC venture, tentatively planned for Nashville, Tennessee. Mark's work at first was partly to share in and to learn from Richard the work Richard was doing and partly to handle some of the pickup, delivery, and related tasks for the first customers the firm acquired. He accompanied Richard on some of the sales calls to Chicago and by the spring of 1974, was making sales calls on his own in Little Rock and Chicago. Mark also was becoming active with civic groups and individuals involved in developing the new port of Little Rock, part of the Arkansas River navigation project.

9 For their warehouse and office, CDC was renting two bays (about 25,000 square feet, well above their usage at that time) in a newly constructed, well-located and equipped eight-bay warehouse building. They also held options to rent up to four of the remaining bays as needed. An adequate supply of racks, pallets, office materials, and the like had been purchased and a forklift truck leased. Arrangements had been made to obtain additional help, as required, from temporary-manpower employment services; these arrangements, with plans to add permanent employees as business developed, were deemed adequate for foreseeable office and warehouse operating personnel needs.

10 By early 1974, it was becoming clear that the sales development efforts of CDC were taking—again, somewhat as expected—a long time to pay off. In many respects CDC was attempting to sell receiving, handling, storage, delivery, and related services of the same sort offered by most public warehouses. By selling these services as a TDC, however—operated by a firm with a carefully developed marketing concept viewpoint and related philosophies—CDC was offering a set of ideas that they believed were uniquely valuable to their prospective customers.

The CDC viewpoint

11 One part of the CDC planning effort developed an outline of the CDC view of its role in the distribution system. In this outline, a distribution system was defined, in effect, as a means of facilitating the several different distribution processes of transportation, warehousing, and so forth. The CDC outline described its own role as a distribution system thusly: "In supporting the customers' marketing effort(s), we 'operate' or integrate the several processes."

12 Based on Carter's years of working with shippers, carriers, and warehousemen—and on the experience of others in the company—the CDC

executives believed the vast majority of companies achieved relatively minimal integration among these different distribution processes and the marketing efforts of the sellers involved. Basically, this was because of the complexity of the activities, the division of labor into highly specialized tasks and agencies, and a still great shortage of persons with the knowledge, experience, breadth of viewpoint, attitudes, and related skills needed to work effectively towards broad-scale integration of effort. For example, the agricultural chemicals division for a major oil company might have several hundred potential dealers in the Midwest and South Central states. Selecting the type, number, and location of wholesale distribution points—or middlemen—in those areas would be a formidable and critical marketing task in itself. Supporting, guiding, and supervising their subsequent promotion efforts, sales forecasts, inventory levels, and customer service activities would be equally challenging and important marketing responsibilities. Help would be needed from specialists in transportation and warehousing. Information and guidance would be necessary in deciding both the initial locations and the continuing operation of these physical distribution services.

13 In deciding upon the locations, for example, the company's physical distribution manager might have to turn to a number of sources of information, such as carriers, warehouse companies, or consultants in deciding whether to ship by rail or motor carrier and in comparing the total cost efforts of the different rates to different sites. He possibly might even query the different sites. He possibly might even query the different common carriers on negotiating a lower type of rate—especially if the sales forecast showed sufficient volume for a given area. Very probably, too, he might ask a public warehousing company for a general quotation on their charges—and receive something like the following:

Warehouse space:
By month—18 cents/square foot; includes utilities, security system, etc.
By year— 15 cents/square foot by month; \$1.70/square foot by year; tenant pays security charges and special utilities; constructs walls, fences, etc.

Small office:
(air-conditioned) \$3.50/square foot/year.

Warehouse labor:
Normal customer \$9/hour.
Contract (40 hour minimum) \$7/hour.
(And so forth, for rates through probably 5 to 10 major headings and 10 to 20 subheading quotations)

14 Alternatively or in further explanation, the following sort of response might be received to the query:

> In general, our handling rates are based on \$1.50 to transport one load into or out of stock one way. Modifications depend upon picking requirements, palletizing involved, or any manual labor needed. Palletizing of

product per case would vary from 3 cents per case to 25 cents per case depending upon the weight and number of people required to palletize. Order picking would vary from 4 cents to 10 cents per case depending upon method of picking, size of orders, and weight of product. Storage is based on square foot and cubic foot utilization as we discussed. The specific question you asked regarding palletized charges per 36-inch height pallets 40 × 48 inches in storage rack would be $1.20 per pallet per month storage. Storage of these same pallets with a stacking limit of two high would be $2 per pallet per month. Clerical charges are normally added into either storage or handling and are based on estimates from operation of similar accounts and customer descriptions of requirements. If the customer desires it can be a separate document (bill of lading, warehouse receiver, OS&D, etc.) charge.

15 Before using such a quotation to arrive at a final cost or rate for his warehousing requirements, the physical distribution manager would obviously have to acquire and calculate considerable data such as sales distribution forecasts; the physical dimensions, packing, and shipping characteristics of his products; and the likely inventory turnover or average storage period. Coordinating these informational tasks with marketing, production, finance, shipping, and other departments in his own company, with different carriers, and with other possible storage facilities may further complicate and delay a decision. The additional communication and negotiation will usually wind up—probably after several days and perhaps weeks—with a warehousing cost figure—e.g., an average of 7½ cents per case sold—that can be plugged in to the company's total cost calculations and profit approximations.

16 Fundamentally, public warehousing charges are mainly of two types: (1) the handling in and handling out or related activity costs, usually at a given price per carton or unit, and (2) the storage costs, quoted as a given charge per month. CDC officials are fairly certain that most warehouse firms (and also most carriers) have insufficient data on relationships between their actual costs of performing their various activities (for different types of goods stored) and the charges they levy for such services. CDC gave special attention to developing such data on their own costs and to relating the prices they charge to such costs. The result (shown subsequently in Exhibit 2) was a pricing structure and method that provided significant advantages both to CDC and to their customers.

17 In further explaining differences between their own distribution center concept and the usual public warehousing operation, CDC included in their outline (of their view of their role) the following excerpted portions:

II. (A) Comparison of public warehousing and (the) distribution center concept.
- A. Customer and warehousing.
  1. Function: Public warehousing.
  2. Activities: Receive, handle in, store, handle out, documentation.
- B. Customer and distribution center.
  1. Function: Support marketing effort.

exhibit 2

*A. Price groups**

Number	*Received*	*Shipped*
1	Unpalleted	Case
2	Unpalleted	Pallet
3	Palleted	Case
4	Palleted	Pallet
5	Unpalleted	Broken cases
6	Palleted	Broken cases
7	Other	Other

B. Price and cost module calculations

The price for each of the six cost groups above was arrived at through a build-up of costs projected for the first year of operations for the entire range of salaries, wages, equipment costs, rental, taxes, and so forth. These costs were grouped into the six cost modules shown below. Fixed and related costs were allocated on bases judged most appropriate by management for the nature of the specific cost item and module. These were figured both in total and per slot projected. Variable costs reflect wage and equipment costs to perform the tasks concerned. Different mixes of resources are required to perform different tasks. Principal tasks were calculated as to minutes required; total costs for these tasks per operation, per slot, and for the entire year were projected.

Module nature and content:

Fixed costs
- Module 1—Salaries, supplies, equipment
- Module 2—Storage area rent, racks, and pallets
- Total fixed costs

Variable costs
- Module 3—Handling in
- Module 4—Handling out
- Module 5—Supplies
- Module 6—Clerical time and costs

*C. Costs and prices per slot for different price groups**

Line		*Source module*	*For group number* 1	2	3	4	5	6
1	Variable costs							
2	Receiving	3	$2.90	$2.90	$1.17	$1.17	$2.90	$1.17
3	Shipping	4	1.76	.82	1.76	.82	2.64	2.64
4	Supplies	5	.40	.40	.40	.40	.40	.40
5	Subtotal (2,3,4)	3,4,5	5.06	4.12	3.33	2.39	5.94	4.21
6	Clerks	6	.44	.44	.44	.44	.44	.44
7	Total variable	3,4,5,6	5.50	4.56	3.77	2.83	6.38	4.65
8	Fixed costs							
9	Salaries, etc.	1	.80	.80	.80	.80	.80	.80
10	Lines 7 and 9	1,3,4,5,6	6.30	5.32	4.57	3.63	7.18	5.45
11	Storage	2	1.60	1.60	1.60	1.60	1.60	1.60
12	Total cost		$7.90	$6.02	$6.17	$4.93	$8.78	$7.05
13	Line 12 index (group 1 = 100)		100	87.6	78.1	62.4	111.1	89.2
14	Price as (line 12 × 125%), per slot*		$9.88	$8.65	$7.71	$6.61	$10.98	$8.81
15	(line 14 − 12, group 1)		1.98					
16	Price as (line 12 + $1.98), per slot*		9.88	8.90	8.15	6.91	10.76	9.03

* The charges shown are for handling in and out and for one month's storage. Additional CDC data permitted rapid conversion to arrive at the appropriate charges for any specific number of days. A *slot* is the space required for one pallet or load of given dimensions.

2. Activities: Relate processes (of transporting, warehousing, etc.) to each other and to the distribution system.

And,

VI. Public warehousemen—CDC.
   A. Warehousemen.
      1. Mechanistic approach.
      2. Assumes rightness of each process or step in the distribution system.
      3. Assumes each process to be discrete step.
   B. CDC.
      1. Environmental approach.
      2. Assumes each process or step to be a variable subject to adjustment to meet customers' objectives.
      3. Assumes the processes to be a continuum in the system; arranges for flow of goods through the process; integrates activities with customers' needs.

CDC's three facets and selling approach

18 In essence, CDC recognized that almost all the services they were offering were—when viewed as separate activities—the same as those offered in varying degrees by the already-existing public warehouse firms. They were firmly convinced, however, that three facets of their operation made them capable of vastly greater potential service—in an overall sense—for every one of their prospective customers. The three facets were:

1. The marketing support systems viewpoint they had adopted.
2. The carefully stated and integrated list of objectives developed by CDC—particularly as these identified CDC responsibilities to its customers.
3. The pricing structure and system established by CDC upon the basis of its cost analyses.

19 The first two facets were interwoven into essentially a single theme which ran throughout a 10-page description of the company's purpose, mission, principal beliefs, objectives, and the implications of these for the company's operations. This description was prepared for the firm's in-house guidance and used on some occasions in selling interviews with prospective customers. Based upon it a promotional brochure was prepared (see Exhibit 1). In the fall of 1973 a mailing of this brochure went to approximately 300 members of the American Association of Physical Distribution Managers (AAPDM). The brochure was also used in sales calls upon physical distribution managers in the Chicago area and in two or three other midwestern cities.

20 The third of the facets which distinguished CDC—its pricing systems—gave CDC the ability to reply almost immediately to customer queries on the price for obtaining warehousing services on given customer needs and an

ability to price on a daily basis. One prospective customer, in a telephone call, described his requirements for storing and wound up with the question, "Can you prepare a quotation on this and get it to me before the end of next week?" The vice president, Mark Kallister, responded: "I can give it to you right over the phone now if you wish." The caller's expression of pleasant surprise was typical of reactions to this aspect of CDC operations. The daily pricing for storage charges—described more fully below—contrasted significantly with usual public warehouse charges for a month or half-month at a time. It was of special import to customers with high turnover of their inventory.

21 In addition to speed and ease in quoting prices, the pricing system gave CDC reasonably high confidence that their prices for different services were based as closely as feasible upon their costs. This implied both that they could be competitive in pricing (assuming they achieved the operational efficiency to which they were dedicated) and that they would avoid accepting unprofitable business. Exhibit 2 shows the price groups and cost modules used to determine the CDC price structure.

The results

22 The mailing of the introductory brochure (Exhibit 1) was designed mainly to introduce the company. Some addressees were persons upon whom phone calls were planned to obtain appointments for a sales interview. Others were ones who might seek further information from CDC and incorporate it into their future physical distribution decisions and plans. Two or three recipients telephoned CDC as soon as they received the brochure and expressed enthusiastic approval of the CDC concepts. One or two very complimentary letters were also received within a few days from other recipients. All of these expressed or implied that their present physical distribution arrangements were well set but that CDC appeared to be a firm of the type with which they would like to do business whenever they had a need to change. No other queries or responses were directly traceable to the mailing. Apparently the brochure did pave the way for several of the sales interviews obtained by the president and vice president on sales trips they made during the late fall and early winter.

23 Both the president and vice president had a very good grasp of general physical distribution concepts and of the CDC viewpoint. Neither, however, had very much in the way of professional sales training or experience. On their sales trips, they first used an AAPDM membership roster and later the Yellow Pages to obtain names of physical distribution managers upon whom to call. They selected mainly larger, more progressive, and well-known companies of a size that were apt to have distribution in the Little Rock area. Telephone calls were then made in an attempt to obtain an appointment for a sales interview. About 25 or 30 telephone calls were required in order to schedule the five or six interviews per day they tried to arrange.

24 Described later by the vice president as largely PR (or public relations) interviews, there was typically no attempt to close a sale or obtain a commitment for some use of CDC services. Normally, the interviews began with a verbal description of Richard Kirk of the CDC firm's background and particularly the ideas underlying its operations. Usually a part of this included a discussion of why CDC had selected Little Rock as the first of its planned locations.[1] Typically, the vice president would then question the prospect about the nature of his company's physical distribution operations and which aspects might be presenting problems. In almost all interviews, the prospects expressed an active interest in the CDC ideas and operations; they also tended to discuss freely their own activities and problems. At the end of the interview, the brochure in Exhibit 1 would be left with the prospects. On only two interviews was the reception inhospitable—but in those instances it was markedly so!

25 From the 40 presentations made in the late fall and early winter trips; about six or seven companies provided enough information and in turn asked the CDC representatives for further information such that Richard and Mark believed they had some really ripe apples to chew on. Prospects at the other companies tended to indicate that if and when they had needs for CDC services they would get in touch with CDC at that time. Upon returning to Little Rock, Richard and Mark usually divided the work of following up the leads they had acquired.

26 For example, one major food products company had indicated that they were studying the process of disposing of a number of company-owned warehouses—in order to free the capital invested—and using public warehouse facilities. They asked for CDC charges on storage and related services for a projected amount of specified goods. Utilizing this information, the food company made initial computer analyses in their Chicago divisional office of the effects on their total costs and profits. When these analyses indicated very favorable results for the use of CDC, the divisional office asked for further information from CDC and made an operations research type of analysis involving 24 computer runs. This analysis compared total costs of using public warehouses in Dallas, St. Louis, and other selected cities in the Midwest. All of these analyses also showed results favorable to the use of CDC.

27 The food company's Chicago division next made a recommendation which went to corporate headquarters in New York. By early spring of 1974, both the physical distribution and marketing offices at the corporate level had concurred with the Chicago recommendation and forwarded it to the

[1] This discussion usually referred to the progressive attitude of people in Little Rock, the city's physical resources (especially the international distribution potential of the port of Little Rock), and CDC's concept of location. This concept is to avoid major distribution cities such as Dallas, St. Louis, and New Orleans, but to seek points where the economic hinterlands of these major cities overlap and where their distribution services are therefore competitively more vulnerable.

corporate finance office. In mid-spring, the finance office recommendation on the matter was part of a series of related recommendations being considered by the corporate policy committee.

28 Although their experience with the food company was somewhat more drawn out than with the others, it was indicative of CDC's experience with all the ripe apple prospects obtained on their selling trips. Two of the firms had to alter their planning because of shortages of raw materials; one was enjoined by the federal energy administration from carrying out distribution channel changes and allocations that would have been involved in moving to the use of CDC; the others required further study and price comparisons before committing themselves.

The CDC anomaly

29 Thus, in early spring 1974, CDC was in an anomalous position. They were still, after a number of months, negotiating with several firms, each of whose business could provide CDC with revenues of thousands of dollars a year. Indeed any one of three of the firms would provide revenue well above \$100,000 annually. In addition, other firms in the Little Rock area, which had contacted or been contacted by CDC in recent weeks, had expressed interest of the same sort as the ripe apples contacted on the Chicago and other selling trips. The company's actual revenues, however, were varying between \$100 or \$200 a month and \$300 or \$400. Only two small-volume customers were really utilizing CDC services on a regularly established basis; a limited number of special or ad hoc jobs had been undertaken and even a couple of these had turned sour.

30 Meanwhile, interest and pressure were coming up ahead of schedule on the long-range objectives and plans of the company—to establish a number of TDC's in economic hinterland areas similar to Little Rock and to move eventually into international distribution activities. For example, one firm is offering to finance, on any of two or three very attractive bases, the construction as soon as feasible of a TDC to be operated by CDC near El Paso, another port of entry. The same firm had also arranged prospective customers for the new TDC; many of these potential customers, because of very poor distribution services and facilities they currently were using, appeared so interested that CDC executives believed signed contracts for use of CDC services could be obtained almost immediately. In addition, some individuals that Mark Kallister (the CDC vice president) had met through civic organizations or social contacts were trying to get some local groups interested in more dynamic development of the port of Little Rock. They were tapping Mark for expert help in these efforts; mention had even been made of having CDC take over management of a TDC in the port complex and perhaps manage the port and its FTZ (free trade zone) itself.

31 Thus, physically, CDC in early spring 1974 was still essentially a two-man operation with an absentee chairman of the board, a small amount of rented

warehouse and office space, a pickup truck, and a leased forklift. The president and the vice president, oftentimes disagreeing on the best sales strategy, were alternating as time permitted between major managerial tasks, selling activities, and warehouse or delivery labor efforts.[2] The vice president, for example, was literally driving a delivery truck on the same day that he would make an evening presentation to some of the state's leading bankers regarding economic development of the Little Rock area and its port.

Carter's role

32 Carter, as chairman of the board for CDC, had steered a middle course through the several months of CDC efforts at sales development. He was determined to leave the presidential and related responsibilities to the two executives hired for those duties. At the same time, his own deep interest and financial involvement in the firm were coupled with frequent occasions when either the president or the vice president called him for guidance of a decision on a major policy point. Long-distance phone calls or fairly lengthy letters were an almost daily flow between Carter and his two men in Little Rock. Many of the exchanges were in regard to specific major tasks; for example, preparing for Carter to visit the investor firm and some of the potential customers at El Paso. A large proportion of the exchanges involved, directly or implicitly, the tasks of operationalizing, reexamining, and—almost always—reaffirming the basic ideas upon which the firm had been originated.

33 For example, one very large manufacturer and assembler of industrial components contacted the CDC people in Little Rock to see if they might obtain more favorable rates and services than they were presently receiving elsewhere. A quickly prepared analysis indicated clearly that CDC could provide the manufacturer decidedly more advantageous rates and services than they currently received. The business would provide CDC with $5,000–6,000 in revenue per month and probable entry into the manufacturer's sizable international distribution (these operations were to be extended to the port of Little Rock in the near future). The same analysis that showed CDC a better alternative than that presently used also indicated rather clearly that the manufacturer would benefit even more by finding a suitable distribution center in the eastern part of the United States.

34 The CDC president and vice president decided to handle the contract in accordance with the following excerpt from the CDC guidelines:

> We commit ourselves to a certain relationship to our customers. . . . For one thing, we may—and will—help our customers devise strategies (and

[2] These disagreements involved such matters as "which department or manager would be best to call on at the Ajax Widget Company?" . . . "spending all that time and money wining, dining, and socializing with prospects is wrong!" . . . "Why didn't you fill me in more on those calls that came from the Ardly-Bend people while I was out yesterday?"

> approaches) to help them attain their objectives which may cause us a loss in revenue.

When notified of and asked to confirm this decision—to recommend to the manufacturer to seek an eastern distribution center—Carter immediately gave his approval.

35 Another series of exchanges among Carter and the Little Rock executives resulted from a lead mentioned casually to Mark one day by a truck carrier salesman visiting the CDC office. Mark followed up and obtained an appointment with the plant traffic manager for a leading national manufacturer's facility located some 30 miles north of Little Rock. The interview quickly disclosed (and secured agreement upon) an opportunity for the firm to obtain major advantages in both rates and service by changing their present methods of routing and shipping a significant proportion of their shipments. As part of this opportunity, CDC approached the common carrier truck line being used by the manufacturer and requested a change from the class-type rate on the rerouted shipments. They cited to the carrier that the changes would result in larger size shipments, that CDC would expedite handling, stacking, and loading of the shipments to allow fuller use by the carrier of his trucks, and that the overall changes would permit lower costs and greater total revenue for the carrier. The proposed commodity rate was greeted with approval by the carrier's management personnel first contacted by CDC; subsequently, however, othe executives in the carrier's organization rejected the idea. In the exchanges that evolved, Richard, Mark, and Carter mutually explored over a period of four or five months several alternatives on how best to serve the manufacturer. The exploration involved, at various times, other carriers, the manufacturer's local plant traffic manager, his divisional marketing and traffic managers in Memphis, and corporate-level marketing and physical distribution executives in New York.

36 Another category of exchanges among CDC executives concerned the need to refine the company's pricing structure. A key advantage of CDC pricing to many customers was its system of charging only for the actual number of days goods were stored. Standard warehouse terms provide that with certain exceptions, "a month's storage charge shall apply to goods stored for any fraction of a month." The exceptions involve mainly a possible agreement between the warehouseman and storer that only one-half month's storage will be charged on goods received between the 16th and the last day of a calendar month. Carter pointed out that CDC's daily pricing system—for many, perhaps most customers—"really turns them on." Mark Kallister also noted that the ability to quote prices quickly was impressive to many prospects and flashy but that practically every customer, before making a commitment to use CDC, required a hard copy quotation. It was in the reaction to these quotations that the need for refinement of the pricing structure was becoming apparent. For example, Carter admitted,

> We may have lost a lot of people (prospects) that way; it puzzles me, but one prospect looked at our quotation and said "your storage charge [com-

ponent] is too high''; he wouldn't use us despite the fact that *his total costs* for using us would be lower. He was having about three months average and six months maximum storage on his goods, was paying $1.50 per case for the first month and 30 cents for each additonal month; our rates were $1.20 for the first month and 35 cents for each added month; but he wouldn't use us because of that 5 cents a month!

37 The general consensus in CDC was that: (1) prices and services competitive with other public warehouses were essential before most customers would become very interested in the additional advantages that CDC might provide; (2) the estimated costs utilized in initial construction of the cost modules were probably too conservative and actual costs were somewhat lower; and (3) the allocation of costs to the storing modules, although conceptually sound, made that component somewhat higher than storing charges quoted by competitors, especially on low-density items where large-cube boxes or material were quite light in weight (e.g., cases of facial tissues).

38 CDC's anomalous situation and a variety of exchanges such as those above were the background against which Carter was considering the letter from Shawn Costello. Shawn was presently serving very successfully as a midwestern sales representative for one of the country's leading railroads. Carter had discussed several times with Richard and Mark the possibility that Shawn would be one of the leading candidates for the next opening whenever CDC might have need to add to its managerial ranks. In the letter Carter had just received, Shawn indicated that he had encountered in sales calls near his home base in St. Louis several firms who appeared to be excellent prospects for use of CDC. And he reiterated his enthusiastic interest in joining CDC as soon as feasible.

39 Carter started thinking more carefully through the probable answers to the questions on which he had started musing earlier.

Appendix: CDC emphasis on trade-off implications as a basis for their TDC

The CDC viewpoint, borne out by experience with a variety of firms, industries, and research, was that their operation as a marketing support system for their customer provided a unique service. Their system's viewpoint and philosophy were: to help their customer fulfill his respective profit and other objectives through finding the optimum combination of transportation, warehousing, and related costs and services. Among the several different actions that could be pursued to an optimum combination might be the following.

1. Reduced transportation costs per unit through such means as:
   a. Finding a more economical type of carrier.

   b. Recommending changes in processing or packing methods so that the customer's goods either:
      (1) Weigh less for shipping purposes.
      (2) Qualify for a lower rate classification.
   c. Recommending changes in *location* of certain processing operations so that the customer may benefit from a more favorable combination of production costs and processing-in-transit, through-type freight rates.
   d. Consolidating the customer's goods with those of other customers to obtain benefit of larger-volume low rates.
   e. Negotiating with carriers for a lower classification or type or level of rate, sometimes on the basis of certain loading or other services the distribution center could perform but that are less feasible for the customer or a regular public warehouse.
   f. Handling or facilitating the making of damage claims or the auditing of carrier's bills (to avoid overcharges).
2. Reducing warehousing and related handling costs by:
   a. Introducing a price system with a charge for storage for only the actual days stored (rather than the traditional monthly storage charge minimum; see the case test for further details).
   b. Seeking storage module sizes, packaging, and other handling or storing features so that a lower rate could be charged.
   c. Suggesting forms of packing, palletizing, or containerizing that might lower handling costs not only in the CDC-TDC but in the customer's plant and storage and/or at other points in the distribution process.
3. Improving or extending service to their customers' customers so that their customers attain a stronger market position; for example, the distribution center might by reason of its location or operating efforts facilitate:
   a. Quicker delivery to their clients' customers.
   b. A lower market price and perhaps resultant sales to customers their client could not otherwise serve.
   c. Lower total inventories both for their client and for their clients' customers.
   d. Provision of market information that might identify market opportunities for their clients.
4. Imaginative and continuing efforts to implement the two key CDC philosophies of *customer-orientation* and a *marketing support system's viewpoint*; for example, CDC might:
   a. Recommend to customers or prospects the use of another city (or storage system) if CDC analysis indicated that other alternatives might be more favorable to the client.
   b. Investigate establishment of a CDC-TDC in another city if a present customer indicated a significant need for such services in the other city for his own distribution there.

section F
Competitive industry analysis

case 27
Note on the lodging industry

1 In 1794, the City Hotel, the first building constructed in the United States specifically for hotel purposes, opened in New York City. Prior to this monumental occasion, travelers were obliged to stay in houses converted into any of a variety of roadside inns. The City Hotel, a 73-room structure, quickly became the focal point for all social activities in New York, a growing town of 30,000. Not to be outdone, the cities of Boston, Baltimore, and Philadelphia soon followed New York with their own lavish hotels.

2 From the late 1700s to Ellsworth M. Statler's 1907 sales promotion (A Room and a Bath for a Dollar and a Half), the lodging industry had indeed come a very long way.

3 Today, the industry boasts some amazing statistics. From its modest beginnings almost 200 years ago, the industry now includes some 40,000 establishments providing over 2.5 million rooms per day, at a nationwide average rate of $36. During the past 20 years, gross annual income for all U.S. lodging establishments has risen from $3,174,286,000 to a projected figure for 1981 that exceeds the $22 billion mark.

4 On a worldwide basis, the figures are even more staggering. Futurists predict that by the end of the century, as larger numbers of people pursue business and personal travel, the travel industry will have become the world's largest. Indeed, that may happen much sooner. "Tourism is second only to oil in total world trade receipts (in 1979)," according to Lord Hirshfield, president of Laventhal & Horwath International. The accounting firm estimates international tourism spending at more than $46 billion in 1977.

This revised edition of an earlier version of this lodging industry note was prepared by Timothy Mescon, Arizona State University, and Richard Robinson, University of South Carolina.

When combined with domestic tourism, the sum soars to about $360 billion, which means that 6 percent of the gross world product was spent on travel.

5 Some of the reasons for this international travel boom include shorter workweeks and longer vacations, rising per capita income, a more stable world economy, lower air fares, and Europeans taking advantage of travel bargains in the United States.[1]

6 Performance indicators for the loding industry are generally divided into four distinct categories: convention/commerical, resort, roadside, and airport. A brief review of occupancy, average rate per room, and sales per room provides some necessary insight into the variations within the industry.

7 Roadside inns lead the industry with an average occupancy of 71.5 percent. Next are airport lodges, 68.4 percent; resorts, 64.6 percent; and convention/commercial properties, 63.3 percent. Class average rates range from a high of $28.14 for resort hotels to $22.36 for airport inns. Not surprisingly, resort hotels/motels demonstrate the greatest yearly sales-per-room figure of $10,729—followed closely by convention/commercial with $10,588, and trailed by airport properties with sales of $9,005 per room yearly.

8 Exhibit 1 provides an overview of the growth and development within the hotel-motel industry.

9 Exhibit 2 offers some insight into yearly occupancy rates compared with rooms available over a 20-year period.

10 Exhibit 3 offers a pie perspective of revenues and expenses within the lodging industry.

11 Exhibit 4 provides a comparison between the 1979 and 1978 performance in the U.S. lodging industry based on a sample of 800 firms nationwide by the accounting firm of Pannell, Kerr and Foster.

The motel industry

12 Since the 1950s the lodging industry has experienced rapid growth in its motel segment. In the early 1950s, the greatest portion of industry sales was generated by hotels in larger cities, with motels accounting for approximately $500,000 (8 percent of total sales). In 1978, motel revenue exceeded $9 billion, representing 78 percent of the hospitality industry sales.

13 Basically, there are five types of motels in the United States today: highway motels, downtown motels, suburban motels, resort motels, and airport motels. Originally, motels were heavily concentrated along a rapidly improving U.S. interstate highway system. Today, however, the occupancy rate of airport motels hovers around the 80 percent mark, while that for highway motels is 71 percent. This situation has been in existence for some seven

[1] *Nation's Business,* June 1979, p. 78.

exhibit 1

U.S. hotel-motel industry: 20-year trend of business for the nation's hotels and motels with payrolls*

	1956	*1961*	*1966*	*1971*	*1976*
Hotels—25 or more guest rooms:					
Number of establishments	10,150	8,830	7,730	7,380	7,310
Number of rooms available per day	844,300	761,350	706,600	700,000	709,100
Average number of rooms per establishment	83.2	86.2	91.4	94.9	97.0
Average number of rooms occupied per day	602,400	518,900	473,900	417,700	450,300
Percentage of occupancy	71%	68%	67%	60%	64%
Gross annual income—all establishments ($1,000)	$2,389,133	$2,533,437	$3,471,825	$4,333,071	$6,041,034
Average annual income per available room	$2,830	$3,328	$4,913	$6,190	$8,519
Motels and motor hotels—all sizes:					
Number of establishments	23,400	27,980	30,600	29,800	30,100
Number of rooms available per day	525,100	833,000	1,062,400	1,196,500	1,315,400
Average number of rooms per establishment	22.4	29.8	34.7	40.2	43.7
Average number of rooms occupied per day	369,900	561,600	705,600	746,200	824,800
Percentage of occupancy	70%	67%	66%	62%	63%
Gross annual income—all establishments ($1,000)	$785,153	$1,468,079	$3,268,298	$4,666,503	$6,729,230
Average annual income per available room	$1,495	$1,762	$3,076	$3,900	$5,116
Combined totals:					
Number of establishments	33,550	36,810	38,330	37,180	37,410
Number of rooms available per day	1,369,400	1,594,350	1,769,000	1,896,500	2,024,500
Average number of rooms per establishment	40.8	43.3	46.2	51.0	54.1
Average number of rooms occupied per day	972,300	1,080,500	1,179,500	1,163,900	1,275,100
Percentage of occupancy	71%	68%	67%	61%	63%
Gross annual income—all establishments ($1,000)	$3,174,286	$4,001,516	$6,740,123	$8,999,574	$12,770,264
Average annual income per available room	$2,318	$2,510	$3,810	$4,745	$6,308

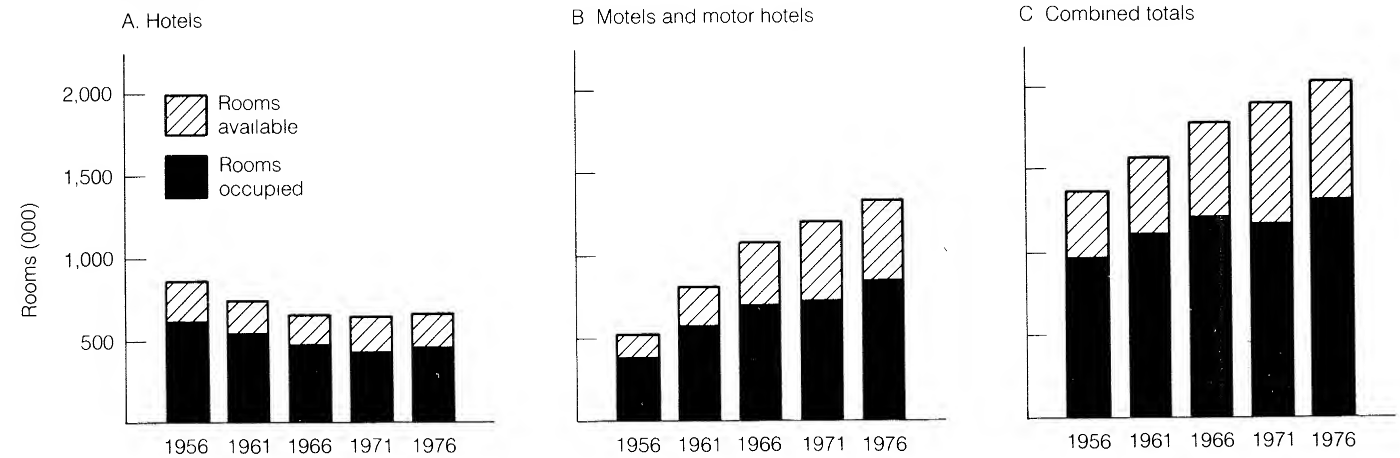
* Based on U.S. census data and Harris, Kerr, Forster & Company estimates.

Note: Estimates for 1976 placed the nation's total number of hotels and motels with payrolls at 37,410 and their guest rooms at 2,024,500. Total revenues approximated $12.8 billion.

Source: *Trends in the Hotel-Motel Industry*, Harris, Kerr, Forster & Company, 1977.

exhibit 2

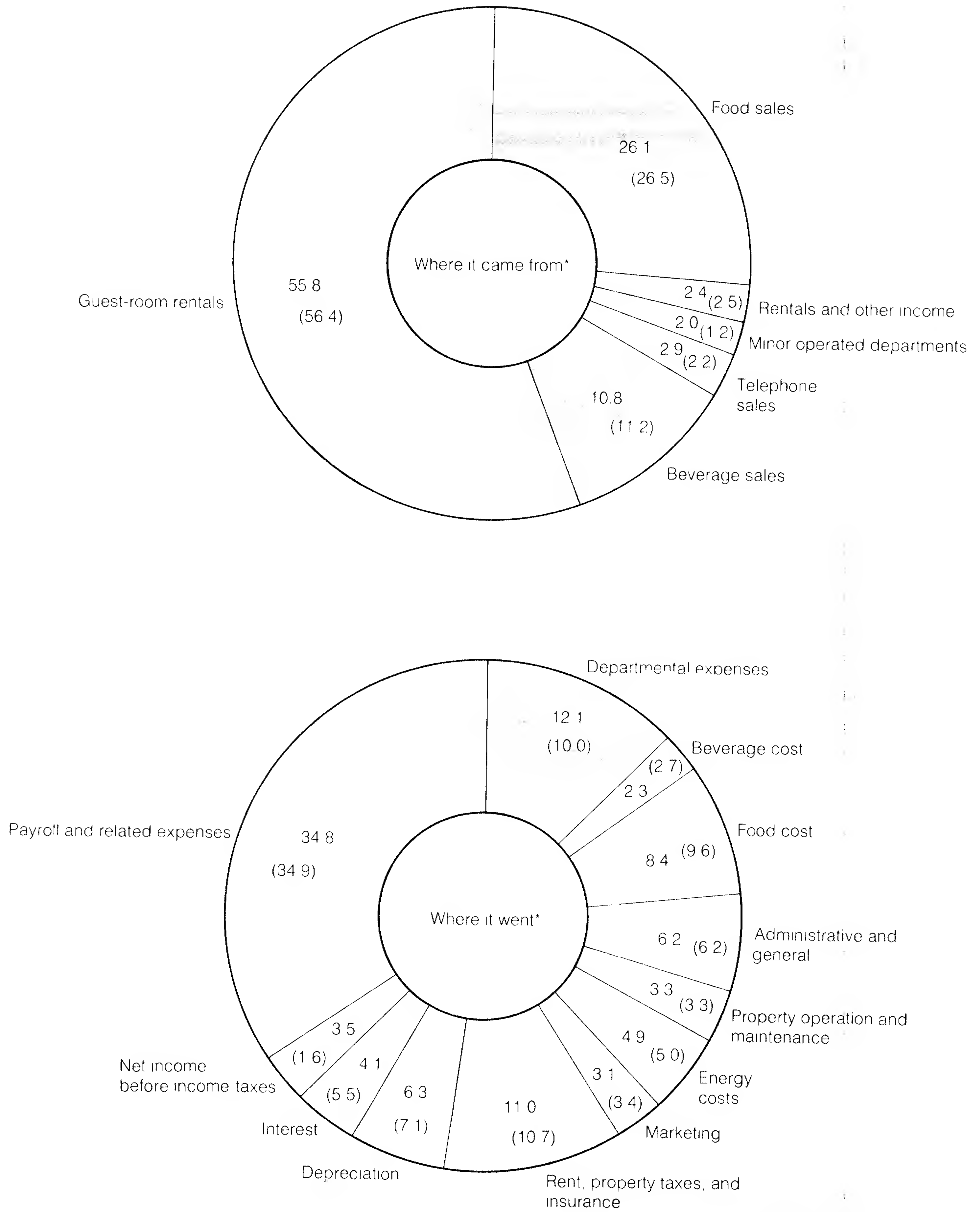
Available rooms and occupancy trends*



		A. Hotels					B Motels and motor hotels					C Combined totals				
		1956	1961	1966	1971	1976	1956	1961	1966	1971	1976	1956	1961	1966	1971	1976
Rooms occupied	(000)	602	519	474	418	450	370	562	706	746	825	972	1081	1180	1164	1275
Rooms available	(000)	844	761	707	700	709	525	833	1062	1196	1315	1369	1594	1769	1896	2024

* For establishments with payrolls. Based on U.S. census data and HKF estimates.
Source: *Trends in the Hotel-Motel Industry,* Harris, Kerr, Forster & Company, 1977.

exhibit 3
The U.S. lodging industry dollar



Note: Based on the arithmetic mean. 1975 amounts (in parentheses) adjusted to conform with changes in *Uniform System of Accounts for Hotels*, 7th rev. ed.
Source: *U.S. Lodging Industry*, Lavanthol and Horwath (Philadelphia, 1977).

exhibit 4
How hotels and motels performed: 1979 versus 1978*

	Showing decreases		Showing increases	
	Number	Percent	Number	Percent
Number of rooms sold	464	58%	336	42%
Number of guests accommodated	488	61%	312	39%
Rooms revenue	88	11%	712	89%
Food revenue	196	28%	504	72%
Beverage revenue	207	33%	427	67%
Total revenues	96	12%	704	88%
Income after property taxes and insurance but before other fixed charges	208	26%	592	74%

1978 level

* Data from 800 randomly selected hotels/motels nationwide.
Source: *Trends in the Hotel Industry: 1980*, Pannell, Kerr, Foster, 1980.

years, during which time highway occupancy levels have been falling, while patronage at airport motels has remained amazingly stable.

14 In an address delivered to the Institute of Air Transport, C. Langhorne Washburn, vice president of Walt Disney Productions, asserted that motels have been the beneficiaries of the phenomenal explosion in U.S. travel. He stated, "A recent *Newsweek* magazine travel and vacation study shows that nearly 70 percent of all U.S. adults took vacations. Nearly 93 percent traveled within the United States, and almost 43 percent within their home states. Almost 30 percent traveled beyond their own geographic regions."

15 In addition to travel, major contributors to motel growth include increased leisure time, disposable income, and the franchise explosion. Exhibit 5 indicates the impact of franchising, among other factors, on the motel industry.

Chains and franchises

16 Chain operations have been in existence in the lodging industry for over 50 years. The boom in chains occurred during the latter stages of World War II and in the years immediately following. During this period the Statler, Hilton, and Sheraton chains began to experience unprecedented growth.

17 Today, Sheraton and Hilton rank sixth and seventh among U.S. lodging chains in terms of total rooms available. (Hilton acquired Statler for $50

exhibit 5
Franchising and the motel industry

Factors	*Franchises**	*Reservation network*†	*Independents*
Percentage of growth since 1969	+183%	+128%	−29%
Percentage of motel industry			
1969	42	24	34
1978	62	32	6
Properties with restaurants	93	78	44
Average number of rooms	98	84	25
Percentage of interstate motels			
1969	52%	30%	18%
1978	61	36	3
Average occupancy rate—1978	72	68	52

* e.g., Holiday Inns, Days Inns.
† e.g., Best Western.

million on October 27, 1954.) The top 25 U.S. lodging chains account for 9,523 properties and report chainwide occupancy rates between 60 and 70 percent. During the period October 1977 to May 1978, Holiday Inns, Inc., Days Inns of America, and Marriott Hotels each added 3,000 or more rooms. La Quinta Motor Inns, Inc., a franchise/company ownership chain that boasts an average occupancy rate of 90 percent, added 1,800 rooms during this period. Quality Inns, Rodeway, Ramada, Hilton, and Hyatt also grew by 1,000 rooms or more. Best Western, the chain of independently owned motels, added 96 properties and 9,000 rooms to its system. Exhibit 6 gives an overview of total properties, rooms, rates, and occupancy for the top 25 U.S. lodging chains, as compiled by *Lodging Industry*. Exhibit 7 offers some insight into the financial requirement for obtaining a franchise hotel-motel operation.

Recent industry developments

18 A 1975 survey conducted by Harris Kerr, Chervenak & Company (an accounting firm, now known as Harris, Kerr, Forster & Company) was designed to examine the impact that technological improvements have had on the lodging industry. The results of this survey—analyzed by Jules A. Sieburgh, an associate with Harris, Kerr, Forster, and included in *Resort Management* (April 1975)—demonstrate two interesting facts.

1. The number of lodging operations that take advantage of the technological advances in the industry are small. Those that have taken a proactive posture, however, have realized lower costs, improved security, and better guest service.
2. A number of operations have ventured into new investments without proper planning and cost analysis. The result has been tremendous expenditure with little return.

exhibit 6
Top 25 U.S. lodging chains

Name of chain	U.S. properties		Status of properties				Average single rate	Average occupancy	Total properties U.S. and foreign	
	Number	Rooms	Company owned	Franchise or members	Manage-ment contract	Other			Number	Rooms
Holiday Inns, Inc.	1,527	244,316	233	1,273	13	—	$24.56	71.2%	1,724	284,306
Best Western, Inc.	1,600	127,733	—	1,600	—	—	24.71	71.0	2,155	148,823
Ramada Inns, Inc.	633	88,388	109	506	10	—	24.00	68.0	667	95,141
Friendship Inns	1,058	82,000	—	1,058	—	—	n.a.	n.a.	1,488	104,000
Budget Motels & Hotels	1,310	80,100	—	1,310	—	—	n.a.	n.a.	1,310	80,100
Sheraton Corp.	334	72,530	21	289	26	—	28.19	68.7	402	98,705
Hilton Hotels Corp.	177	64,113	18	129	30	—	37.90	70.0	177	64,113
Howard Johnson Co.	525	58,246	134	391	—	—	n.a.	80	532	59,160
TIMOA, Inc.	315	46,475	—	315	—	—	n.a.	n.a.	315	46,475
Days Inns of America	296	42,370	131	165	—	—	13.88	70.7	297	42,492
TraveLodge Int'l/Trusthouse Forte, Inc.	482	34,760	35	204	—	277*	n.a.	n.a.	516	37,240
Quality Inns	277	30,000	31	246	—	—	21.50	66.5	285	31,000
Hyatt Hotels Corp.	53	27,000	—	—	53	—	n.a.	n.a.	53	27,000
Motel 6, Inc.	242	24,090	242	—	—	—	9.45	n.a.	242	24,090
Marriott Hotels	51	20,925	35†	16	—	—	n.a.	n.a.	56	23,000
Red Carpet/Master Hosts	138	17,588	3	134	8	—	21.00	73.1	145	18,850
Rodeway Inns of America	141	17,450	—	141	—	—	20.00	70.0	145	18,000
Western Int'l Hotels	23	15,000	23†	—	—	—	n.a.	70.0	50	26,000
Hotel Systems of America	70	9,000	—	60	10	—	18.75	70.0	70	9,000
La Quinta Motor Inns, Inc.	71	8,195	56	15	—	—	17.50	90.0	71	8,195
American Travel Inns	125	7,500	—	125	—	—	n.a.	n.a.	125	7,500
Americana Hotels	12	7,270	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	12	7,270
Dunfey Family Hotels & Motor Inns	24	7,175	16†	—	—	—	n.a.	n.a.	25	8,025
Radisson Hotel Corp.	19	6,990	7	—	12	—	28.42	60.0	20	7,105
Stouffer Hotels	20	6,954	9	7	4	—	35.00	72.0	20	6,954

n.a. = not available.
* Includes joint-venture properties.
† Includes all corporate-managed properties, not necessarily owned by the chain.
Source: *Lodging Hospitality*, August 1978.

exhibit 7

Obtaining a franchise: What it takes to join a chain or referral group

	Franchise/membership requirements					Franchise/membership fees				
Name of chain	*Minimum number of rooms*	*Food facilities*	*Meeting space*	*Pool*	*Laundry*	*Initial fee*	*Royalty*	*Advertising fee*	*Reservations fee*	*Other fees*
Admiral Benbow Inns	60	•		•		Negotiable	2½% of gross room sales	1% of gross room sales	None	None
American Travel Inns	20					$1,800+$18 for each room over 20 up to 150 rooms	$500/year + $20/room over 20 up to 50	10¢/room/day	$200/year + $1.85/completed reservations	$40/month + $4/room over 20 up to 100; 66¢ up to 150 rooms
Best Western, Inc.	None					$2,040 + $18 for each room over 20	None	7¢/room/day	7.2¢/room/day	Monthly, annual dues
Budget Host Inns	None					None	None	None	None	$200/year dues; sign rental
Budget Motels & Hotels	None	•				$100 affiliation fee	None	None	$2/unit/month	Sign purchase; directory fee
Coachlight Inns	40			•		$5,000	2% of sales	1% of sales	None	None
Days Inns of America	60			•	•	$15,000 up to 100 rooms; $100/rooms over 100; $60 for restaurant	3% of gross sales	6¢/room/day	90¢/booking + $1.75/room/month + 0.6% of gross room sales	Training fee: 1¢/room/day
Downtowner/ Rowntowner/ Passport Inns	50	•	•	•		Downtowner/ Rowntowner new property: $10,500; conversion: $7,500;	3% of gross room sales	1½% of gross	$2.45/confirmed reservation	None
						Passport Inns: $2,450 + $15 for each room over 50	$1,250/year + $5 for each room over 50	$950/year + $5 for each room over 50	$2.45/confirmed reservation	None
Econo-Travel Motor-Hotels	48				•	New property: $5,000; conversion: $1,500	3.92% of gross revenues	1% of gross revenues	$3/reservation call	None

exhibit 7

Obtaining a franchise: What it takes to join a chain or referral group

Franchise/membership requirements						Franchise/membership fees				
Name of chain	*Minimum number of rooms*	*Food facilities*	*Meeting space*	*Pool*	*Laundry*	*Initial fee*	*Royalty*	*Advertising fee*	*Reservations fee*	*Other fees*
Friendship Inns	None	•				None	\$20/room/year	None	None	None
Hilton Hotels	100	•	•	•		\$150/room to 100 rooms; then \$100/room; not to exceed \$50,000	5% of room revenue	None	Per reservation	None
Holiday Inns	None	•	•	•		\$20,000 + \$150/room over 100	4% of gross room revenue (includes HI University and sign fee)	1.8% of gross room revenue	None	Holidex: \$3/room/month
Howard Johnson	100	•		•		\$20,000	5% of gross room sales	None	Confidential	None
Interstate Inns	30				•	\$3,000	10¢/room/day	None	None	Sign lease: \$150/month 1st 3 years, then \$75/month
Knights Inns	100		•	•	•	\$75/room	3% of gross room sales	8¢/room/day	None	Will manage for 5% management fee
Magic Key Inns	15				•	\$150	\$9/room/year	None	None	None
Quality Inns	75	•		•		New property: \$15,000 + \$75/room over 100; conversion: \$7,500 + \$25/room over 100	3% of gross room sales	15¢/room/day	\$1.75/room/month /month + \$1.25/reservation	None
Ramada Inns	60	•		•		\$100/room; \$15,000 minimum	3% of gross sales	\$4.41/room/month	\$450 terminal rental + 1% of gross room	1¢/room/day training fee

Red Carpet Inns/ Master Host	60	•		•		Red Carpet Inns new property: $10,000; conversion: Master Hosts, $2,500	$2/room/month	4¢/room/day	None	None
Regal 8 Inns	80			•		$2,500	2% of gross room sales	1% of gross room sales	None	None
Rodeway Inns	70	•	•	•		New property: $15,000; conversion: $7,500	3% of gross room sales	13¢/room/day	$3.75/room/month	Sign lease or purchase based on sign selected
Save Inns of America	80	•		•		$5,000 study fee	10% of gross room sales above sales level before property is franchised	None	None	None
Scottish Inns of America	80	•		•		$20/room/month	1%	1%	$1/room/month + $1.50 net confirmed reservation	Sign rental
Sheraton Corp.	100	•	•	•		$15,000	4% of gross room revenues	None	1.6% of gross room revenues; minimum $4.50/room/month; maximum $6.50/room/month	None
Superior Motels	15					$230	$1.25/room/month paid annually	None	None	None
Super 8 Motels	21				•	$15,000	4%	1%	None	None
Timoa Inns	50	•		•		$1,250 to $2,500	$500/year	$1/room/month	$2.25/reservation	Sign lease
Travel Lodge	None	•	•			$100/room; not less than $10,000	2½% of gross room sales	3½% of gross room sales	Included in ad fee	None
Treadway Inns	75	•	•	•	•	$50/room; no fee for conversions	3%	½ of 1% of room sales	$3/confirmed reservation	Sign lease
Western Motor Lodges	None					$10/unit/year; $200 minimum, $700 maximum	$10/room/year	None	$2.85/INRES reservation	$116 sign purchase

Source: *Lodging Hospitality*, August 1978.

Some of the innovations in the industry are as follows:

1. Within the last four years, almost a dozen computer companies have invested over $20 million in research and development concerning specialized data processing systems for resort hotel-motel operations. The new systems have introduced significant improvements to a variety of functions, including reservations, room management, back office accounting, and marketing analyses.
2. The Federal Communications Commission's "Carterfone" decision permitted the use of privately owned interconnect telephone systems. This decision has forced over 60 manufacturers and more than 200 distributors of telephone equipment to provide a variety of novel services and many new tariff variations.
3. Conventional key locks and bolts have been replaced by a number of sophisticated electronic security devices, many of which are part of a central computer system. Other security services such as fire and smoke detectors, emergency paging, and security guard monitoring systems have been recently introduced.
4. More than 75,000 hotel-motel rooms in the United States are now equipped with standard television sets with special channels available for the airing of in-room movies. There is a standard charge of $3 per showing, and the in-room movie has proved a popular and successful innovation throughout the industry.
5. Savings in energy costs have become a high-priority commitment among lodging operations. Two interesting energy savers are *soft-start lighting*—which brings light bulbs to full power over a short period of time, thereby reducing maintenance labor and increasing light life—and *end-load controllers*—which regulate the amount of power at the receiving devices. In many instances, the combination of temperature control, peak power demand control, and other energy regulation devices generates the potential for a savings of up to 40 percent on the total energy dollar expenditure.

20 In summarizing his views on the turbulence in this sector of the industry, Sieburgh wrote:

> Equipping a new resort or modernizing an established one was once relatively easy. . . . Call the telephone company and tell it how many rooms need phones. . . . Order from National Cash Register a Class-42 front-office machine, a few Class-5 cash registers and a Class-33 bookkeeping machine. . . . Handle security by counting the number of doors and ordering the same number of locks. . . . Don't worry about energy-saving equipment, since power is cheap. . . . Ignore most time-saving devices, since a few extra people don't really cost that much. . . . End Of Problem!
>
> Those happy, carefree days are gone, because a technological explosion is occurring in the lodging industry and unless you take practical advantage of new techniques, your resort may become noncompetitive.

The new technology is reaching into almost every area of operations, including comprehensive on-line computer systems, automated room status, new security systems, automated wake-up, electric telephone switchboards, in-room movies, automatic temperature control, peak power demand control, automatic telephone shutoff . . . the list seems endless.[2]

Foreign tourism's growing importance

21 In 1980, foreign tourism receipts accounted for an estimated $12 billion in U.S. export earnings. This places tourism as the fourth most important export earner in U.S. industry, exceeded only by chemicals, motor vehicles and parts, and grain and cereal preparations. The year 1980 marked the first year in which there were more tourists from overseas (8.1 million) coming to the United States than Americans visiting overseas (8 million).

22 Expenditures by foreign visitors in the United States have been growing faster than other measures of U.S. economic activity. Between 1970 and 1979, according to *Nation's Business*, these expenditures grew more than 250 percent, well ahead of the growth of the gross national product (up 141 percent) and U.S. personal consumption expenditures (up 144 percent). The majority of foreign tourism expenditures goes to food and lodging (62 percent), with travel a distant third.

23 While overseas visitors exceeded Americans going overseas in 1980, travel between neighboring countries (Canada and Mexico) kept the United States from a favorable total travel balance—22.8 million Americans abroad versus 22.2 million foreigners visiting the United States. Expenditures by foreign tourists in the United States in 1980, according to the U.S. Travel Service (USTS), were:

Mexico	$2.5 billion	West Germany	$500 million
Canada	2.4 billion	United Kingdom	470 million
Japan	775 million	France	215 million

24 Tourists from abroad vary considerably in their travel and expenditure patterns. For example, USTS reports Canadians are strongly auto-oriented, with less than 20 percent using the services of travel agencies, and staying an average of nine days per visit; West Germans use travel agencies more and travel to more places, averaging 24-day visits; Japanese travel largely on all-inclusion tours, stay in first-class hotels and frequent Hawaii, Guam, and the West Coast; Latin Americans emphasize shopping in their visits, spending about $3.7 billion each year.

25 Canada and Mexico consistently account for the largest number of foreign tourists with 11.4 million and 2.7 million, respectively. For the first time, 1980 saw Mexico overtake Canada as the leading source of tourist revenue.

[2] "Technological Explosion in the Lodging Industry," *Resort Management*, April 1975.

More than 1 million 1980 tourists were from Japan, which has ranked third since early 1972. By 1982, visitors from the United Kingdom are expected to rival the Japanese in numbers.

26 Devaluation of the dollar, along with a lower rate of domestic inflation than that of many overseas countries, has turned the United States into a vacation bargain. Expanded air routes have made the United States more accessible.

27 Best Western, recognizing the bargain a devalued dollar generates for foreign tourists, has led major U.S. chains in recent efforts to attract this growing market. They have recruited over 852 new international affiliates in 18 countries, ostensibly to increase familiarity with the Best Western name. Best Western is also changing its name (to Western International) and familiar crown symbol to add international flavor.

28 J. W. Marriott, Jr., president of the Marriott Hotel chain, reflects the predominant view within the industry. In a recent interview with *U.S. News & World Report,* Marriott was asked "Have an influx of foreign visitors taxed hotel facilities in some key areas?" His response:

> Yes, but it's a key element in only a few cities. People coming to the United States from Europe want to see New York and they want to see Washington. If they have enough money, they may go someplace else—perhaps Disney World in Florida. Travelers coming from Asia generally go to Los Angeles, San Francisco, and Las Vegas—and maybe to Hawaii. But that's about the extent of it. Only a half-dozen cities are affected to any extent by pressures from overseas visitors.

29 A major problem in accommodating foreign travelers is the language barrier and other practices these travelers are accustomed to. J. S. Linen, president of American Express's travel division, makes the following observation:

> We, as a country, including the travel industry, have not been geared for anything other than English. We need to break the one-language barrier and develop multilingual servicing capabilities . . . from customs declaration forms to hotel menus and front desk information. We need to replace English-only signs with symbols to identify common locations such as restrooms, mail drops, dining rooms in hotels, and transportation facilities throughout the country.
>
> Most international travelers are used to changing currency with ease in banks and hotels abroad. By comparison, few U.S. banks and hotels have developed these relatively simple capabilities.
>
> Foreign visitors also face widespread problems with acceptance of prepaid hotel vouchers issued abroad, and few have any clear idea of how big this country is.
>
> The most significant segment of the international travel market is the pleasure traveler, and until these visitors can feel comfortable traveling in the United States, we're losing a valuable potential market.[3]

[3] *Nation's Business*, May 1981, p. 63

Multiuser, big city location boom

30 By early 1979, travelers in major urban markets like San Francisco, New York, Chicago, Denver, Kansas City, Miami, and Los Angeles were facing a 19th-century problem—a place to stay is hard to find. In 1978 alone, Holiday Inns refused more than 200 million guests for lack of space.

31 What is causing this growing discrepancy between supply and demand? Some of the reasons behind an increasing shortage of hotel rooms in these metropolitan, multiuser areas are more and bigger conventions, increasing business travel, an influx of foreign visitors and a general boost in travel, spurred by low-cost air fares. Mark Van Hartsvelt, director of franchise planning for Holiday Inns, sees several underlying factors that will continue increased demand:

A steady increase in the number of families with incomes in excess of $20,000—a group that rents four times as many room-nights as those with lower incomes.

A predicted 50 percent rise in the number of individuals aged 35 to 49, the group with the greatest propensity for travel.

The growing independence of women, who are traveling more for business and pleasure and have more money to spend.

The declining birthrate, giving adults more time and money for trips.

Increasing worldwide use of air travel—which means multiuser, often metropolitan areas close to airports are where demand will grow, not roadside locations.[4]

32 Responding to these pressures, most major hotel chains have set into motion major expansion plans for the metropolitan, multiuser markets. By early 1979, industry analysts were projecting a need for 145,000 new rooms *annually* over the next 20 years.

33 A major difficulty for hotel operators in these major metropolitan areas is the variance in peak occupancy. San Francisco, for example, has two peak periods. June through August brings hordes of tourists, while September and October fill hotels with conventions. New York, however, often remains sold out from September to May. Washington, D.C., peaks during March–May and October–November, with Monday through Thursday being consistently sold out while weekends incur heavy vacancy. Exhibit 8 provides occupancy rates for 1978 and 1979 in 11 major U.S. cities.

34 Even with the seasonal cycles, which are not anything new to the lodging industry, lodging industry participants look bullishly at major city markets as the decade of the 70s draws to a close. Even with an ever-present, energy-related threat to this fuel-dependent business, so many people are convinced the big city hotel boom will continue that the American Hotel and Motel Association has had to install a hotline for investor queries.

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[4] *Nation's Business*, June 1979, pp. 76–80.

exhibit 8

Monthly occupancy rates in selected cities and states, 1979 versus 1978

1979	*Average for year*	*Dec.*	*Nov.*	*Oct.*	*Sept.*	*Aug.*	*July*	*June*	*May*	*April*	*Mar.*	*Feb.*	*Jan.*
Atlanta, Ga	69%	47%	71%	72%	67%	69%	71%	75%	70%	74%	77%	72%	68%
Boston, Mass.	77	54	79	94	88	88	77	84	86	83	73	63	60
Chicago, Ill.	67	43	66	83	73	71	67	78	76	67	63	60	56
Denver, Colo.	70	54	64	71	74	84	75	75	67	64	76	69	69
Los Angeles, Calif.	79	64	74	84	80	88	83	86	82	81	85	83	71
Miami, Fla.	77	73	76	71	63	72	75	66	70	84	89	96	85
New York, N.Y.	81	67	84	92	88	86	74	87	87	84	80	78	70
Philadelphia, Pa.	62	47	60	74	62	64	57	70	73	68	61	57	55
San Diego, Calif.	80	63	75	80	82	94	82	80	73	80	91	86	72
San Francisco, Calif.	86	64	84	95	92	96	92	91	90	85	91	82	70
Washington, D.C.	72	43	69	82	79	72	66	79	87	86	79	66	58
States and regions:													
Colorado	68	52	57	67	73	85	77	74	62	60	74	70	65
Montana	69	47	61	75	73	86	80	81	72	72	69	63	51
New Mexico	69	49	58	78	72	81	74	79	73	67	71	67	60
New York State	79	64	80	90	86	85	73	85	84	81	77	74	67
Virginia	61	41	55	75	68	68	61	70	70	69	60	50	44
3 Rocky Mountain states*	68	48	57	63	75	83	76	77	60	66	73	65	53
Nationwide averages†	71%	52%	67%	79%	73%	78%	72%	76%	76%	75%	75%	69%	64%

1978	Average for year	Dec.	Nov.	Oct.	Sept.	Aug.	July	June	May	April	Mar.	Feb.	Jan.
Atlanta, Ga	68%	49%	68%	73%	66%	73%	67%	71%	75%	70%	69%	70%	66%
Boston, Mass.	77	55	77	90	91	87	78	85	84	81	74	64	60
Chicago, Ill.	67	47	68	78	75	71	64	77	71	73	60	60	64
Denver, Colo.	73	50	64	73	78	89	82	82	69	67	75	69	70
Los Angeles, Calif.	77	61	71	81	81	89	84	84	76	76	80	78	70
Miami, Fla.	72	72	75	71	61	70	65	58	67	75	83	90	76
New York, N.Y.	79	68	85	90	85	81	73	83	86	79	75	73	68
Philadelphia, Pa.	61	49	60	71	61	63	60	70	67	67	59	53	54
San Diego, Calif.	80	58	69	81	84	94	92	81	78	79	85	87	71
San Francisco, Calif.	82	61	84	94	94	95	93	86	82	78	82	72	63
Washington, D.C.	72	43	62	81	80	69	66	80	84	87	79	68	57
States and regions:													
Colorado	70	50	55	66	76	89	84	81	63	65	75	67	64
Montana	72	49	63	69	77	87	88	80	67	69	67	63	52
New Mexico	70	53	60	74	75	78	79	80	71	70	72	62	62
New York State	77	64	81	87	84	81	73	82	84	77	72	70	65
Virginia	62	40	56	73	67	73	67	71	71	73	57	50	42
3 Rocky Mountain states*	69	47	53	62	76	86	86	80	63	68	75	62	53
Nationwide averages†	67%	50%	68%	75%	72%	75%	71%	72%	72%	70%	68%	63%	59%

*3 Rocky Mountain states include Nebraska, Utah, and Wyoming.
†Estimated occupancies for nation's total hotel-motel industry.
Source: *Trends in the Hotel Industry: 1980*, Pannell, Kerr, Foster, 1980.

35 The Motel Brokers Association foresees a tremendous movement by investors to the southern and southwestern areas of the United States. According to J. Linwood Ric, executive director of the association, "Most buyers are coming from northern tier states and buying in the Sunbelt. This is particularly true of buyers of small properties." Certainly climate and population growth have helped to spur this intensive effort in the Sunbelt, an area which includes such states as Texas, California, Colorado, Nevada, Georgia, Florida, and Arizona. Exhibit 9 provides a look at motel sales activity during 1977.

36 The popularity of this region has attracted a number of foreign investors. Helen Naugle, the Motel Brokers Association president, notes that "nearly 80 percent of the motels in the San Francisco Bay area are owned by foreign investors. In Las Vegas they own well over 60 motels. They're buying for immigration purposes, and they're continuing to come."

37 According to G. W. Lattin, however, an expert in hotel-motel management, investors take a rather apprehensive view of the financial solvency of the lodging industry. He wrote: "When it comes to providing an answer to the question, What does the future hold?, my crystal ball comes up a little hazy. Although written a number of years ago, the following statement from *Forbes Magazine* is, in my opinion, the best answer:"

> Those who say that in 5 or 10 years hotels will boom again probably are overoptimistic; those who say they will never boom again, though some hotels and motels will continue to make money, probably are too pessimistic. The only really safe statement to make is this: in the long run the chains will probably become profitable again. But even this prediction must be hedged. They will prosper again, *provided* they manage their affairs well in the critical days just ahead.[5]

Lodging industry diversification

38 In an effort to broaden their earnings base, several major lodging participants are diversifying into related business areas. Casino gaming has received the greatest attention in recent years. Since casinos often include hotel, food, and beverage facilities, several major lodging firms including Holiday Inns, Hilton, Hyatt, and Ramada Inns have moved into casino gaming. Gerald Hallier, chief operating officer of Ramada Inns, Inc., offers the following scenario:

> Even established companies that are doing well in Nevada, such as Del Webb, Caesars World, and Summa, don't have as good a chance as the big companies because they lack the base (from which) to expand. In the long run, it's the big companies like Holiday Inns, Ramada Inns, and Hilton which will do the best, because they have the muscle.[6]

[5] "From Doghouse to Drawing Room," *Forbes*, May 1, 1968.

[6] "Holiday Inns: Refining Its Focus to Food, Lodging—and More Casinos," *Business Week*, July 21, 1980, p. 104.

exhibit 9
Nationwide motel brokers study of 106 motel sales during 1977

Southwest sales:	
Average number of units	42
Average sales price	$551,250
Average down payment	$107,000 (18%)
New financing (after sale)—14 years	8.5%
Average sales price times gross	3.45
Average price per unit	$11,941
Northwest sales:	
Average number of units	37
Average sales price	$600,031
Average down payment	$94,370 (15%)
New financing (after sale)—18 years	8.5%
Average sales price times gross	4.1
Average price per unit	$16,162
Northern Midwest sales:	
Average number of units	26
Average sales price	$271,000
Average down payment	$58,000 (19.9%)
New financing (after sale)—18.7 years	8.2%
Average sales price times gross	3.79
Average price per unit	$10,311
Southern Central sales:	
Average number of units	47
Average sales price	$500,000
Average down payment	$84,000 (21%)
New financing (after sale)—17 years	8.2%
Average sales price times gross	3.5
Average price per unit	$10,569
Rocky Mountain sales:	
Average number of units	34
Average sales price	$442,894
Average down payment	$74,000 (20%)
New financing (after sale)—18.5 years	8.3%
Average sales price times gross	4.09
Average price per unit	$13,464
Eastern states:	
Average number of units	34
Average sales price	$432,575
Average down payment	$84,000
New financing (after sale)—14 years	8.5%
Average sales price times gross	4.3
Average price per unit	$12,722
National averages:	
Average number of units	36
Average sales price	$466,291
Average down payment	$83,561 (18%)
New financing (after sale)—17.8 years	8.4%
Average sales price times gross	3.87
Average price per unit	$12,528

Source: Denise Turk, "Why Motel Sales Are Booming," *Lodging Hospitality*, August 1978, p. 81.

Hallier seems quite accurate as Holiday Inns, in just three years, has become the largest firm in casino gaming by mid-1981.

39 Exhibit 10 shows the rate of casino gaming growth since 1970. At a compounded annual rate of over 17 percent, casino gaming is quite attractive to established lodging firms with obviously related competencies. In the Las Vegas market alone, visitor spending has tripled in eight years as shown in Exhibit 11. And since Atlantic City legalized gambling in May 1978, gross wins have steadily exceeded projections.

40 Aside from Nevada, where casino gambling has been sanctioned since the late 1940s, Atlantic City is the only other location in the United States to permit casinos. The attraction to Atlantic City is based primarily on its proximity to major East Coast population centers. While it is believed that this market is currently attracting patrons living within 75 miles of the city, there is a vast potential market of some 60 million living within a 300-mile radius. This compares with 16 million persons within the same distance of Las Vegas.

41 Historically, the gaming industry has been the ultimate growth business, with revenues increasing in each succeeding year. Although gains have moderated somewhat during economic contractions, gross revenues have continued to climb. Inflation does not seem to have a significant negative impact on the earnings of gaming companies, since the amount of money wagered tends to rise with inflation. Some industry insiders believe that gambling increases during economic downturns because people are looking for ways to take their mind off their problems; the hope for a good winning streak can be a powerful inducement.

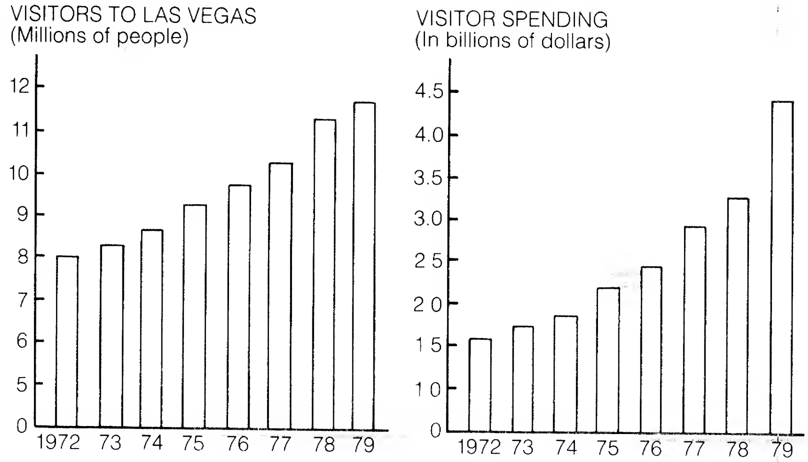
42 The expansion in Nevada and New Jersey underscores the seemingly insatiable demand for gambling in this country. It has been estimated that more than $100 billion is wagered annually; this figure includes illegal gambling. Most states now permit some form of wagering, such as bingo, horse

exhibit 10
Domestic casino gaming ($ millions)

Year	*Clark County (Las Vegas)*	*Washoe County (Reno/Tahoe)*	*Total Nevada*	*Atlantic City*	*Total United States*
1980*	1,550	475	2,330	600	2,930
1979	1,424	423	2,120	325	2,445
1978	1,236	367	1,846	134	1,980
1977	1,016	280	1,519	—	1,519
1976	847	230	1,262	—	1,262
1975	770	193	1,126	—	1,126
1974	685	170	1,004	—	1,004
1973	586	159	858	—	858
1972	476	138	731	—	731
1971	399	133	633	—	633
1970	369	116	575	—	575

*Estimated by Standard & Poor's.
Source: Nevada State Gaming Control Board; Resorts International; and New Jersey Casino Control Commission.

exhibit 11
Las Vegas tourist activity: 1972–1979



Source: Las Vegas Convention/Visitors Authority.

and dog racing, lotteries, and jai alai. Some individuals feel that competition from private enterprise is the best method of eliminating the criminal element from gambling.

43 Legislatures have recognized the potential economic benefits that can be derived from the legalization of casino gaming. The fees and taxes generated by casinos would be welcome by most governmental units. Fees and taxes collected by Nevada in 1979 totaled $101.5 million, and the tax rate in New Jersey is currently 12 percent.

44 The New York State legislature recently approved eight different bills that would permit casino gaming. Since passage by two consecutive legislatures is required before a constitutional amendment can be put on the ballot for voter approval, this action gives the legislature another year to determine the form that casino gaming could take, as well as where it would be located. The legalization of casino gaming in New York could significantly impact the growth of the Atlantic City market. This would be particularly true during winter months, when many residents would prefer to do their gambling closer to home. Other states assessing legalization include Massachusetts, Illinois, and Pennsylvania.

45 Another diversification area for lodging firms has been the family restaurant business. Both Holiday Inns and Days Inns initiated moves in this direction in late 1978. Holiday Inns acquired Perkins Cake and Steak, Inc., a 340-unit, midwestern restaurant chain. Days Inns initiated its own restaurant chain, DayBreak, on a limited basis. While promising numerous lodging-related synergies, expansion of these ventures (and movement by other lodging firms) was virtually halted by the 1979–80 economic downturn.

The future

46 Most lodging chains are optimistic about the future, but they keep a wary eye on changes in their critical dependence on energy (gasoline and fuel). Best Western, for example, has projected a 17 percent decline in auto travel if gasoline reaches $2 a gallon. Holiday Inns disagrees, predicting no real change in *highway* travel if $2 a gallon is reached.

47 Most experts see the lodging industry as sensitive to fuel-cost and general economic cycles. First to feel the pinch of gasoline price hikes and shortages, the reasoning goes, will be facilities that are reached mainly by automobile. But hotels in the big cities could also suffer if fuel costs/shortages lead to increased air fares, fewer flights, and an end to bargain packages. The brief 1973–74 Arab oil embargo cost the U.S. tourism industry $717 million and 90,000 jobs according to the American Hotel and Motel Association. And regarding general economic cycles, the damage can be twofold. First, early investment in new rooms can result in rooms coming on stream when demand is slackening. Second, as other businesses cut travel-related expenditures in a sluggish economy, the demand for rooms can drop significantly in major metropolitan locations.

48 The *Business Week* (Exhibit 12) article illustrates the rapid changes that can hit the lodging industry participant in a short time span. In early 1979, as we saw earlier in this note, lodging firms were bullishly expanding major metropolitan locations. By early 1981, the date of this article, conditions had changed dramatically. But while this type of short-term swing is rather common in the lodging industry, most major chains still see major growth ahead for the lodging industry worldwide.

49 The accounting firm of Pannell, Kerr, Foster (formerly Harris, Kerr, Foster), which has followed the hotel/motel industry for over 40 years, sees productivity as the key opportunity area for the 1980s. They make the following observation based on their analysis of 20-year trends (see Exhibits 13, 14, 15):

> The continuing, strong demand for accommodations—particularly in major markets—led to high occupancy rates and to spot shortages of rooms in 1979. Demands were particularly high for better facilities with more luxuries at ever-increasing costs. People appeared willing to pay more for larger rooms, particularly to secure work space for business meetings, seminars, and convention activities. Reports on increased rates indicate that guests were apparently willing, during 1979, to pay the price for amenities and special services. Contributing to these higher rates, in turn, were commitments by operators to establish larger, more ornate public areas; to provide larger guest rooms in new and refurbished facilities; and to increase the quality and number of services provided.
>
> Extending the analysis of 1979 statistics for their impact on the future of hotel and motel operations in the United States, it appears that the industry has peaked in its ability to increase revenues through improved occupancy

rates which have been at exceptionally high levels. In the future, hotel and motel operators will have to look beyond rate increases covering increased costs to real productivity increases, if profit margins are to be maintained or improved. This assumes that it will be more difficult to pass through inflationary costs in the future.

exhibit 12

A Glut of Hotel Rooms Just as Business Dips

The hotel business is being pummeled around the nation. Recession is keeping vacationers home, and inflation is discouraging business travel and driving room rates to astronomical levels. With few exceptions, occupancy rates for major operators in the first two months of 1981 were off, in some cases sharply. Yet a huge stream of new rooms is coming to market in many cities and costs are escalating, forcing hoteliers to try to salvage profit margins with operating economies, special promotions, and a harder eye on expansion plans.

"It will be a very difficult business climate for the hotel business in the months ahead," says LeRoy A. Judge, vice president of Hilton Hotels Corp. "This January we saw a precipitous fall—we were off six points." February and March will be down about three percentage points, he says, and "this is also the first time we saw any softness in the New York City market." Stouffer Corp.'s hotels recorded a three- to four-point drop in occupancy in the first two months of 1981, and at Hyatt Corp., business plummeted as much as 20 percent in some areas and at least 10 percent in most others. Some chains, such as Holiday Inns, Sheraton, and Marriott, reported less significant occupancy declines so far this year to *Business Week* correspondents in a nationwide survey, while only one major operator, Ramada Inns, said it was experiencing an increase—of 1.3 points. "We expect the first half to be rough," says a Sheraton spokesman.

Higher commissions. To boost volume, hotels are offering more weekend discounts, corporate rates are being frozen by several chains—Hyatt seems likely to continue its plan beyond its announced cutoff in June—and business-meeting organizers may find rates more easily negotiable. Radisson Hotel Corp. is boosting the commission it pays to travel agents to 15 percent from 10 percent for bringing in guests on slow nights and will grant a 2 percent discount for prompt payment of bills, while the Harley Corp. chain is offering 25 percent off the first night's room rate.

The lodging industry typically lags behind an economic downturn by one or two quarters, as cutbacks in advance business and leisure travel plans begin to be felt. But the current crunch is compounded by rising air costs—"the most profound reason" for the downturn, says Hilton's Judge. Domestic air traffic in the first two months of 1981 fell about 10 percent from the comparable year-ago period, the Air Transport Assn. estimates. "If you don't have people in airline seats, you don't have people in hotel rooms," says Albert Kuderle of the American Hotel & Motel Assn., whose members had sales of about $23.8 billion in 1980.

About 70 percent of that business is generated by business travel and meetings, Kuderle says, and hotels that rely on this business are feeling an acute pinch from company efforts to restrain travel costs. Occupancy at the 1,000-room Hyatt Regency Atlanta in January and February, for example, was down seven points from a year ago to 78 percent. "There's a lot of early departures," says vice president and general manager Edward W. Rabin Jr. "We expected to see a spurt

exhibit 12 ***(concluded)***

in corporate meetings to discuss their strategies'' in light of Reagan Administration policies, says Hyatt senior vice president Joseph G. Kordsmeier. ''But it hasn't happened.'' Airport hotels and motels in many cities are finding customers much harder to come by than their downtown competitors.

Fewer foreign tourists. The rising strength of the dollar against foreign currencies and Europe's recession is cutting the flow of foreign tourists and businessmen, which helped produce a five- or six-point decline in occupancy rates so far this year at the New York Hilton at Rockefeller Center, a bellwether of the huge New York City market. Occupancy rates in New York are down about 10 percent overall, according to hotel broker Stephen W. Brener. He figures average room rates rose 20 percent last year to above $60.

But the one-two punch of air fare increases and the recession on vacation travel has hit hardest in Florida and Hawaii, where occupancy declines of 10 percent to 20 percent are common. In Hawaii, ''the group business has fallen to pieces,'' says Robert W. Holden, head of Sheraton's Hawaii, Far East & Pacific Div. ''That's your middle-income people.''

In cities serving strong regional economies, such as Dallas and Houston, Denver, Boston, Hartford, and Stamford, Conn., business is healthy and developers believe it will balance ambitious building plans. Marriott, Stouffer, and Hyatt intend to pursue hefty expansion. But some operators and investors are cautious. Hilton's Judge says a large number of Hilton's proposed projects are being held back ''until we get a better look at the economic climate.'' and Equitable Life Assurance Society, which has equity in 35 hotels, is ''being very selective in new investment,'' says George R. Puskar, vice president.

Many hotelkeepers predict a second-half recovery, but there is increasing worry about profits. ''There's a limit to raising rates to offset the drop in occupancy,'' says New York Hilton general manager Jorgen H. Hansen, ''Profit margins are going to be squeezed, unquestionably.''

Source: *Business Week,* March 13, 1981.

exhibit 13
Major metropolitan area hotels/motels selected revenue and expense items: 20-year trend

Revenues per available room

Year	Rooms	Food	Beverages	Telephone	Other operated departments	Rentals and other income	Total revenues
1960	$ 3,931	$2,646	$ 998	$270	$202	$233	$ 8,280
1965	3,918	2,483	987	239	198	227	8,052
1970	5,134	2,709	1,144	269	222	256	9,734
1975	6,333	3,197	1,300	331	227	268	11,656
1976	7,272	3,528	1,363	397	241	293	13,094
1977	8,105	3,782	1,458	430	256	307	14,338
1978	9,407	4,385	1,647	476	276	330	16,521
1979	11,104	4,844	1,805	506	323	387	18,969

Costs expenses, and income—per available room

Year	Departmental costs and expenses	Undistributed operating expenses	Property taxes and insurance	Total operating costs and expenses	Income after property taxes and insurance*
1960	$4,532	$1,665	$342	$ 6,539	$1,741
1965	4,378	1,642	384	6,404	1,648
1970	4,956	2,075	516	7,547	2,187
1975	6,091	2,868	627	9,586	2,070
1976	6,675	3,187	658	10,520	2,574
1977	7,197	3,534	701	11,432	2,906
1978	8,112	3,952	689	12,753	3,768
1979	9,076	4,569	642	14,287	4,682

	Ratios to total revenues				*Cost per dollar of sales*		
Year	Rooms revenue	Food revenue	Beverage revenue	Other revenues and income	Food	Beverages	Combined
1960	47.5%	31.9%	12.1%	8.5%	34.1¢	29.8¢	33.0¢
1965	48.7	30.8	12.3	8.2	33.7	27.7	32.1
1970	52.7	27.8	11.8	7.7	32.1	23.8	29.8
1975	54.3	27.4	11.2	7.1	33.5	22.1	30.2
1976	55.5	27.0	10.4	7.1	32.6	21.5	29.4
1977	56.5	26.4	10.2	6.9	32.5	21.2	29.2
1978	56.9	26.5	10.0	6.6	33.3	21.5	30.0
1979	58.6	25.5	9.5	6.4	33.6	21.2	30.1

			Ratios to total revenues			
Year	Percentage of occupancy	Average room rate	Total operated departments' income	Income after property taxes and insurance*	Property taxes and insurance	Payroll and related costs
1960	73.4%	$14.48	45.3%	21.0%	4.1%	38.0%
1965	71.9	14.95	45.6	20.5	4.8	37.9
1970	68.2	20.75	49.1	22.5	5.3	37.4
1975	63.1	27.55	47.7	17.8	5.4	38.3
1976	66.5	29.85	49.0	19.7	5.0	37.5
1977	68.3	32.50	49.8	20.3	4.9	37.2
1978	71.5	36.04	50.9	22.8	4.2	35.7
1979	72.3	42.05	52.1	24.7	3.4	34.8

* The income after property taxes and insurance, wherever it appears in this study, is before deducting depreciation, rent, interest, amortization and income taxes.

Source: *Trends in the Hotel Industry: 1980,* Pannell, Kerr, Foster, 1980.

exhibit 14
Resort area hotels/motels selected revenue and expense items: 20-year trend

Revenues per available room

Year	*Rooms*	*Food*	*Beverages*	*Telephone*	*Other operated departments*	*Rentals and other income*	*Total revenues*
1960	$ 3,955	$2,781	$ 890	$105	$ 348	$ 310	$ 8,389
1965	4,440	2,942	1,008	115	404	332	9,241
1970	5,749	3,530	1,280	155	522	487	11,723
1975	8,488	5,078	1,723	193	743	640	16,865
1976	9,515	5,511	1,821	200	806	670	18,543
1977	10,574	6,005	1,965	244	874	746	20,408
1978	11,751	6,357	2,078	267	1,118	855	22,426
1979	12,960	6,829	2,214	291	1,438	1,031	24,763

Costs expenses, and income—per available room

Year	*Departmental costs and expenses*	*Undistributed operating expenses*	*Property taxes and insurance*	*Total operating costs and expenses*	*Income after property taxes and insurance**
1960	$ 4,556	$2,032	$218	$ 6,806	$1,583
1965	4,936	2,037	265	7,238	2,003
1970	6,356	2,613	349	9,318	2,405
1975	8,983	4,005	443	13,431	3,434
1976	9,721	4,337	471	14,529	4,041
1977	10,526	4,787	530	15,843	4,565
1978	11,304	5,284	606	17,194	5,232
1979	12,448	5,887	608	18,943	5,820

	Ratios to total revenues				*Cost per dollar of sales*		
Year	*Rooms revenue*	*Food revenue*	*Beverage revenue*	*Other revenues and income*	*Food*	*Beverages*	*Combined*
1960	47.1%	33.2%	10.6%	9.1%	35.4¢	29.3¢	34.1¢
1965	48.1	31.8	10.9	9.2	34.1	24.4	31.7
1970	49.1	30.1	10.9	9.9	33.4	22.2	30.5
1975	50.3	30.1	10.2	9.4	34.6	21.2	31.1
1976	51.3	29.7	9.8	9.2	33.8	21.0	30.6
1977	51.8	29.4	9.6	9.2	33.3	20.6	30.1
1978	52.4	28.3	9.3	10.0	34.2	21.2	31.0
1979	52.3	27.6	8.9	11.2	34.8	21.4	31.5

			Ratios to total revenues			
Year	*Percentage of occupancy*	*Average room rate*	*Total operated departments' income*	*Income after property taxes and insurance**	*Property taxes and insurance*	*Payroll and related costs*
1960	65.4%	$16.46	45.7%	18.9%	2.6%	35.7%
1965	66.5	18.25	46.6	21.7	2.9	33.8
1970	67.0	23.70	45.8	20.5	3.0	35.9
1975	71.7	32.36	46.7	20.4	2.6	34.9
1976	73.8	35.29	47.6	21.6	2.6	34.9
1977	74.8	38.75	48.4	22.4	2.6	34.7
1978	75.6	42.58	49.6	23.3	2.7	33.6
1979	74.5	47.64	49.7	23.5	2.5	33.7

* The income after property taxes and insurance, wherever it appears in this study, is before deducting depreciation, rent, interest, amortization and income taxes.
Source: *Trends in the Hotel Industry: 1980,* Pannell, Kerr, Foster, 1980.

exhibit 15
Roadside chain motels selected revenue and expense items: 20-year trend

Revenues per available room

Year	*Rooms*	*Food*	*Beverages*	*Telephone*	*Other operated departments*	*Rentals and other income*	*Total revenues*
1960	$2,685	$1,975	$ 737	$165	$19	$ 88	$ 5,669
1965	3,106	1,984	767	161	21	99	6,138
1970	4,037	2,081	803	187	24	110	7,242
1975	4,926	2,447	1,028	242	26	117	8,786
1976	5,542	2,583	1,060	285	26	121	9,617
1977	6,299	2,719	1,141	314	28	129	10,630
1978	7,076	2,816	1,188	336	34	142	11,592
1979	7,880	2,873	1,252	358	54	156	12,573

Costs expenses, and income—per available room

Year	*Departmental costs and expenses*	*Undistributed operating expenses*	*Property taxes and insurance*	*Total operating costs and expenses*	*Income after property taxes and insurance**
1960	$3,065	$ 940	$179	$4,184	$1,485
1965	3,109	1,098	225	4,432	1,706
1970	3,478	1,438	309	5,225	2,017
1975	4,413	2,052	368	6,833	1,953
1976	4,732	2,250	382	7,364	2,253
1977	5,082	2,493	403	7,978	2,652
1978	5,428	2,762	355	8,545	3,047
1979	5,740	3,048	354	9,142	3,431

	Ratios to total revenues				*Cost per dollar of sales*		
Year	*Rooms revenue*	*Food revenue*	*Beverage revenue*	*Other revenues and income*	*Food*	*Beverages*	*Combined*
1960	47.4%	34.8%	13.0%	4.8%	38.9¢	29.1¢	36.0¢
1965	50.6	32.3	12.5	4.6	37.3	27.0	34.3
1970	55.8	28.7	11.1	4.4	36.4	25.8	33.3
1975	56.1	27.8	11.7	4.4	37.7	24.1	33.5
1976	57.6	26.9	11.0	4.5	36.7	23.6	32.8
1977	59.2	25.6	10.7	4.5	36.4	23.2	32.4
1978	61.1	24.3	10.2	4.4	37.9	24.0	33.7
1979	62.7	22.9	10.0	4.4	38.8	23.9	34.1

			Ratios to total revenues			
Year	*Percentage of occupancy*	*Average room rate*	*Total operated departments' income*	*Income after property taxes and insurance**	*Property taxes and insurance*	*Payroll and related costs*
1960	65.9%	$11.08	45.9%	26.2%	3.2%	28.0%
1965	70.7	11.92	49.3	27.8	3.7	28.0
1970	68.8	16.04	52.0	27.9	4.3	29.1
1975	65.9	20.43	49.8	22.2	4.2	31.0
1976	69.2	21.87	50.8	23.4	4.0	31.0
1977	72.1	23.93	52.2	25.0	3.7	30.3
1978	75.0	25.85	53.2	26.3	3.0	29.7
1979	73.3	29.46	54.3	27.3	2.8	29.5

* The income after property taxes and insurance, wherever it appears in this study, is before deducting depreciation, rent, interest, amortization and income taxes.

Source: *Trends in the Hotel Industry: 1980,* Pannell, Kerr, Foster, 1980.

case 28

Holiday Inns, Inc. (B)

1 Holiday Inns, Inc., enters the 1981 summer season as quite a different company from the Holiday Inns, Inc., of the 1970s. Under founder Kemmons Wilson, who retired in mid-1979, Holiday Inns' executives defined their operations as part of the travel business, seeking to rationalize a broad-based diversification program. Under this definition, Holiday Inns eventually entered over 30 different businesses from furniture manufacturing to the operation of buses that the company anticipated would funnel some customers to its inns.[1] This rapid diversification taxed management capabilities at Holiday Inns. In addition, the underlying travel-related assumptions proved to be unrealistic in several instances. Corporate strategists failed to foresee, for example, that few bus passengers were likely to stay at medium- to high-priced hotels, or that hotel franchisees might balk because Holiday Inn produced furniture that was more expensive than the products of alternative sources.[2] Since assuming the chief-executive officer (CEO) position in 1978, Roy Winegardner recognized the failure of the travel-related philosophy and has sought to change it. Commenting on this change in an interview with *Business Week,* Winegardner recently said:

> We are in the process of reshaping Holiday Inns into a different company. Holiday Inns is actually a "hospitality" company—a concept that will limit its scope to food, lodging, and entertainment. . . . In the future the company will get into as few businesses as possible, and only those that have good growth, high returns, and are synergistic with our main business—hotels.[3]

Key changes in 1979

2 In August 1979, Holiday Inns sold its Trailways bus operations to a private investment group for $94 million. The divestiture of Trailways reduced 1979 net income by $15.4 million, reflecting a small operating loss ($270,000) to the date of sale, plus a loss of $15.2 million on disposition. Although taking a loss on the sale, Holiday Inns removed an unrelated, poorly performing business from its corporate portfolio. Of equal importance to Holiday Inns,

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This case was prepared by Richard Robinson, University of South Carolina.

[1] The majority of these businesses, 26 in the early 1970s, were part of Holiday Inns' sprawling products group.

[2] *Business Week,* July 21, 1980, p. 104.

[3] Ibid.

the sale generated over $90 million in cash to partially underwrite its rapid movement into casino gaming.

3 In July 1979, Holiday Inns formed a joint-venture company with Harrah's (of Nevada) to develop, build, and operate all future gaming facilities for both companies. In September 1979, a merger agreement was approved by both firms.[4] Later that month, the joint-venture company purchased the Chalfonte Hotel site on Atlantic City's Boardwalk for $27 million. Through the merger, Holiday Inns acquired ownership of Harrah's existing operations in Reno and Lake Tahoe, Nevada. These are two of Nevada's major casino operations, totaling 108,000 square feet of casino space and 865 hotel rooms. Under the merger, Harrah's will maintain its identity as a wholly-owned subsidiary and be the gaming operations arm of Holiday Inns, Inc., commenting on the merger with Harrah's, a Holiday Inn executive said:

> We could not have picked a better company than Harrah's, a leader in the hotel/casino and entertainment industry. The control measures developed by Harrah's are now the standards for the industry. They provide seasoned expertise in gaming and big name entertainment contracting. Their growth record has been superior.

4 In August 1979 Holiday Inns, Inc., acquired a 40 percent interest in River Board Casino, Inc., which owned the Holiday casino contінguous to the Holiday Inn hotel in Las Vegas. Holiday Inns, Inc., also started construction on a 500-room hotel and 44,000-square-foot casino in the Marina area of Atlantic City based on a 1978 joint-venture arrangement with L&M Walter Enterprises in Atlantic City.

5 Within the products group, Holiday Inns sold Dohrmann (the West Coast restaurant—supply sales arm of the products group) in early 1979. This sale reduced the products group to two operating divisions (Inn Keepers Supply and Innkare), down from a high of 26 different businesses in the mid-1970s. Renamed the products division, this drastically streamlined operation was restructured as a component of the hotel group, with a strategy designed "to refocus it more toward supporting the company and meeting Holiday Inns' franchisees product needs." Several mamangement changes were made within the products division during this reorganization. Most notably, Raymond Schultz, formerly senior vice president for franchising on the hotel group, became the head of the products division. Schultz's former position apparently reflects Holiday Inns' concern with past unsatisfactory experiences of some franchisees in dealing with the old products group.

6 By the end of 1979 Holiday Inns, Inc., had nearly completed its transformation into a "hospitality company" from a "hotel company with unrelated operations in transportation and some 30 other areas." Commenting on this swift transformation, Winegardner said:

---

[4] This merger was subsequently approved by the companies' shareholders on February 28, 1980.

> Our strategy for the coming decade will be to grow consistently from our leadership base in the hospitality industry with major positions in the closely related fields of hotels, casino gaming, and restaurants. Each has significant potential and we plan to capitalize on the opportunities offered by these three exciting growth markets. By the mid-1980s, as our casino gaming projects start operations. We project our hospitality-related earnings mix to be 55–60 percent generated by our core hotel business, 25–35 percent from casino gaming, and the balance from our freestanding restaurant operations.

7 With this new focus as a hospitality company, the next several sections examine how the company has performed in the early 1980s.

Hotel group

8 In 1980, 12,785 new rooms were added to the Holiday Inn system. In July, the system opened its 300,000th guest room, as part of an ongoing, intensive expansion program, that in 1980 saw the opening of a new hotel at the rate of more than one per week. As part of an aggressive effort to upgrade the overall quality of its hotel system, nearly 5,500 rooms (company owned and franchised) were removed for a variety of reasons including changing market needs or failure to adhere to strict quality standards. At year-end, 1,755 hotels in 59 countries comprised the Holiday Inn system. While Holiday Inn maintained a dominant market position, Best Western surpassed it in the total number of properties (2,800 versus 1,755), although Holiday Inns' number of rooms remained 33 percent (down from over 50 percent in 1978) greater than Best Western. Internationally, an aggressive development program is under way, particularly in South America, Mexico, Europe, and the United Kingdom. At the end of 1980, the international Holiday Inn system consisted of 210 hotels with 44,179 rooms, up 10 percent over 1978. In 1981, the Holiday Inn system expects to add 19 new international properties with more than 4,000 rooms.

9 In total, the company and its franchisees are expected to spend nearly \$3.5 billion over the next five years on new hotel development and reinvestment in existing properties. By year-end 1981 about 50 percent of the hotel system will be newly constructed or will have recently undergone major renovation.

10 In 1980 the new Holidex II network booked about 33 million room-nights, more than a third of all system reservations, and several times more than competing hotel chains. Percentagewise, this is down 50 percent from mid-1970 levels. Conversion to the new state-of-the-art worldwide reservations system will be completed by the end of 1981.

11 In concert with expanded Holidex II computer capabilities, Holiday Inns' *operations management systems* (OMS) was developed to improve profits at the hotel level. Consisting of weekly department forecasts, energy control, staff scheduling, inventory control, industrial engineering, and quality as-

surance, the system was fully implemented in approximately three fourths of its company-owned or operated properties by 1981. The program helped improve margins on a consistent basis, even where occupancies declined temporarily.

12 Another new internal program—Inn level business planning—calls for careful monitoring of trends in the local market environment, including product competitiveness, rates, opportunities, and competitive developments. This market-by-market monitoring enables each hotel to stay abreast of, and react quickly to, changing competitive situations.

13 Another technological area that holds great promise is statellite communications, a realm in which Holiday Inns, Inc., is pioneering with its HI-NET system. This network of earth stations, now operational at 148 company and franchised properties throughout the United States, brings free first-run movies, sports, and variety programming to hotel guests in their rooms. The HI-NET service also is available to customers for satellite video conferencing of meetings and educational seminars, a fast-growing new market in multi-use located hotels.

14 Occupancy of Holiday Inns, Inc.'s properties declined for the second year in a row to 71.5 percent in 1980, down from 73.8 percent in 1979 and 74.3 percent in 1978. General economic weakness, a decline in family disposable income and rapidly increasing airline fares were given as primary reasons.

15 The hotel group had fewer company-owned room-nights available in 1980. For the past six years, the company has concentrated heavily on the quality and location of company-owned and operated hotels. As a result, new rooms added during that period were more than offset by rooms removed for market and product quality control reasons. With this emphasis, hotel group performance and profitability hit a new high as shown in Exhibit 1. System-wide financial performance is provided in Exhibits 10, 11, and 12 at the end of the case.

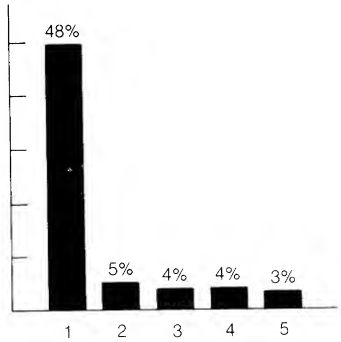
16 Capital expenditures and steady system-wide expansion reflect corporate management's confidence in the future profitability of the hotel group. Management points to strong, continued brand preference as clear evidence of Holiday Inns' continued industry leadership (see Exhibit 2).

exhibit 1
Company-owned Revenue and Profitability ($ millions)

	1980	*1979*	*1978*	*1977*	*1976*
Rooms	$434.5	$402.1	$364.8	$320.9	$290.0
Food and beverage	187.7	178.2	172.0	153.6	148.2
Product services	117.7	115.7	148.1	143.6	137.2
Eliminations and other	109.1	87.6	80.0	86.6	69.1
Total revenues	$849.0	$783.6	$764.9	$704.7	$644.5
Operating income	$154.6	$137.4	$121.2	$ 95.7	$ 69.7
Operating margin	18.2%	17.5%	15.8%	13.6%	10.8%

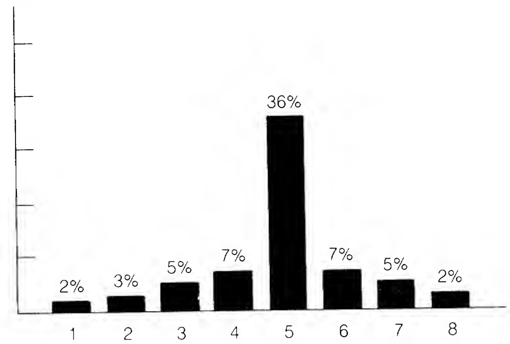
exhibit 2
Hotel brand preference*

1978



1. Holiday Inns, Inc.
2. Ramada Inns, Inc.
3. ITT Sheraton Corporation.
3. Howard Johnson Company.
5. Hilton Hotels Corporation.

1980



1. Hyatt
2. Howard Johnson
3. Hilton
4. Best Western
5. Holiday Inn
6. Ramada
7. Sheraton
8. Marriott

* Thinking about all the hotels or motels you know, which is your first choice to stay at when you travel? From the 1980 Ad Track study conducted by Holiday Inns, Inc., among past-year hotel motel lodgers.

Casino group

17 Gaming in Nevada is celebrating its 50th anniversary in 1981, although it is one of the youngest and fastest-growing segments of the hospitality industry.

18 U.S. casino gaming industry revenues reached $3 billion in 1980, compared to $2.4 billion in 1979, a 25 percent increase despite the impact of the 1980 recession and escalating transportation costs. In 1980 Atlantic City nearly doubled its 1979 casino revenues, winning more than $600 million. Forecasts made in 1976 when casino gaming was first legalized in New Jersey predicted the Atlantic City market would not reach $800 million in gaming revenues annually until 1988. Many industry experts now expect Atlantic City to gross $1 billion in gaming revenues in 1981.

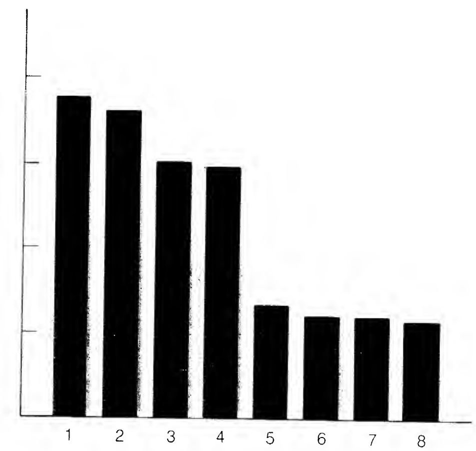
19 Through its entry into casino gaming operations less than two years ago and its expansion track record since then, Holiday Inns, Inc., has kept pace with the spectacular industry growth. With the November 23, 1980 opening of Harrah's Marina hotel/casino in Atlantic City, Holiday Inns, Inc., became the largest U.S. gaming concern, operating alone or in partnership the most slot machines, 5,656; most table games, 439; and most casino space, 188,200 square feet. Holiday Inns, Inc., is the only company with properties in all four major U.S. gaming centers (See Exhibit 3). In 1980 gaming accounted for 13 percent of the hospitality operating earnings of Holiday Inns, Inc.

20 Harrah's is the Lake Tahoe gaming market leader with a 43 percent market share, and its facility there is uncontested as Nevada's finest hotel/

exhibit 3

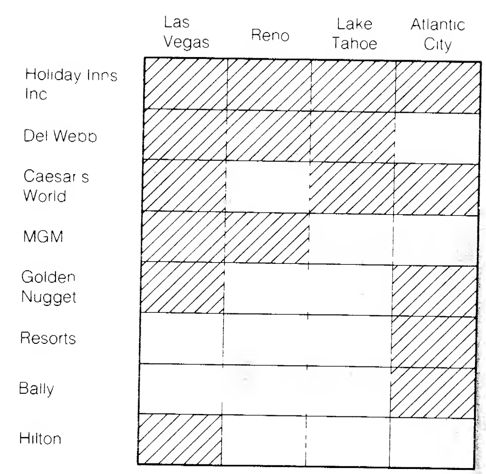
U.S. gaming industry in 1980

A Largest gaming companies in U S A
in terms of casino square feet

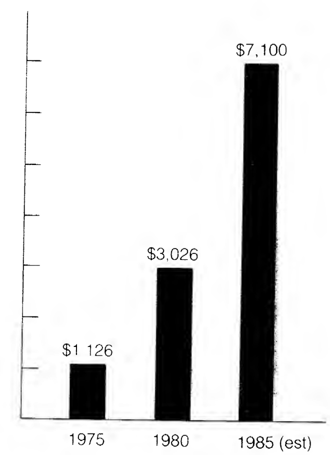


1. Harrah's, 188,200.
2. Del Webb, 180,000.
3. MGM, 150,000.
4. Caesar's World, 148,000.
5. Golden Nugget, 65,000.
6. Resorts, 60,000.
7. Bally, 60,000.
8. Hilton, 58,000.

B Gaming representation in major U S markets



C U S gaming revenues ($ millions)



Source: Nevada Gaming Control Board, New Jersey Casino Control Commission, and 1985 (estimated) industry projection.

casino. Concern for protection of the Tahoe basin environment will probably halt further casino development in the foreseeable future, allowing Harrah's to continue to take advantage of its leadership role. While Holiday Inns' Lake Tahoe market share is sizable, its market share is considerably less in the other major growing markets as shown in Exhibit 4.

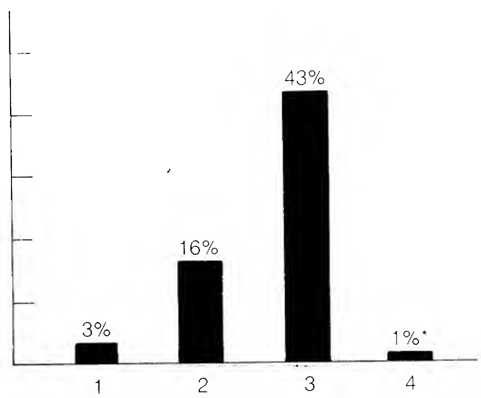
21 Commenting on Holiday Inns' rapid success in casino gaming, Mike Rose (HI president) offered management's view of the gaming future:

> Harrah's management depth and the strength of its operating programs and systems place Holiday Inns, Inc., in an excellent position to capitalize on the future growth of gaming. The company is already the largest in terms of facilities and has begun to establish successfully a nationally recognized brand name. These accomplishments, together with innovative marketing and planning, will put the company in the same leadership position in gaming that it enjoys in the lodging industry.

22 Indeed, numerous traditional competitors share the same view. Hilton Hotels Corp. and Hyatt Corporation have already entered the field and are doing quite well. Gerald E. Hollier, chief operating officer at Ramada Inn, echoed Holiday Inns' optimism in a recent *Business Week* interview:

> As the gaming industry expands rapidly, smaller companies will have difficulty keeping up with market growth. Even established companies that are doing well in Nevada, such as Del Webb, Caesars World, and Summa, don't have as good a chance as the big companies because they lack the base

exhibit 4
Holiday Inns, Inc.: 1980 gaming group market share by location (in percent of market gaming revenues)



1. Las Vegas.
2. Reno.
3. Lake Tahoe.
4. Atlantic City.

* Facility opened late November. Captured 12 percent of December revenues.

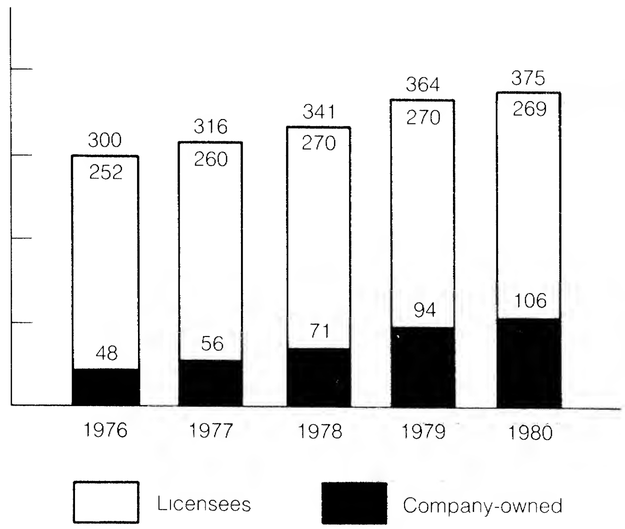
(from which) to expand. In the long run, it's the big companies like Holiday Inns, Ramada Inns, and Hilton which will do best, because they have the muscle.[5]

23 Only two major lodging competitors, Best Western and Days Inn, are not pursuing casino gaming. Best Western president Robert Hazard sees gaming as "an infatuation that could burst like a bubble," while Days Inn executives consider gaming outside the concept and corporate philosophy underlying Days Inn.

Freestanding restaurants

24 Holiday Inns' move into freestanding restaurants remains limited to the Perkins Cake and Steak chain. The number of Perkins units has gradually expanded, with the focus being almost exclusively on company-operated restaurant growth as shown in Exhibit 5.

exhibit 5
Number of Perkins stores



25 Perkins' 13.8 percent increase in revenues for 1980 over the full-year 1979 was primarily driven by the opening of 15 new company stores. Because of the difficult economic environment experienced throughout the restaurant industry during the past two years, and because many of the new Perkins units were in new markets, operating results were disappointing. Average

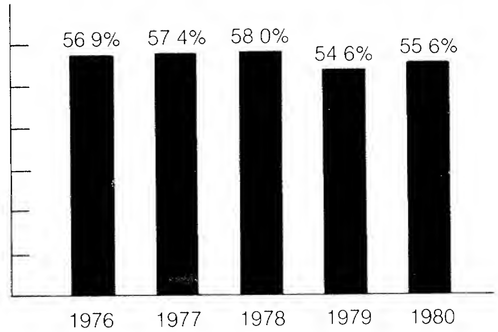
[5] Business Week, July 21, 1980, p. 104.

customer count per store was down 13.3 percent in 1980 and 14.9 percent in 1979, although the trend was less negative in the second half of 1980. A typical company-owned Perkins restaurant has an average annual volume of nearly $900,000. Many of the older and smaller franchised units have annual revenues of approximately $600,000.

26 Analysis showed certain company units to be a major drain on earnings. Three units were closed in 1980, and provisions were made for losses through estimated dates of disposition for an additional four closings to be made in 1981. The provisions negatively impacted operating income by $1.8 million in 1980. New store development was halted until economic conditions improve.

27 A noticeable ongoing strength was Perkins' ability to control costs, as shown in Exhibit 6. Food and labor costs totaled a respectable 55.6 percent of sales, and corporate overhead as a percent of sales declined. Addtional information on Perkins' financial performance is provided in Exhibit 12.

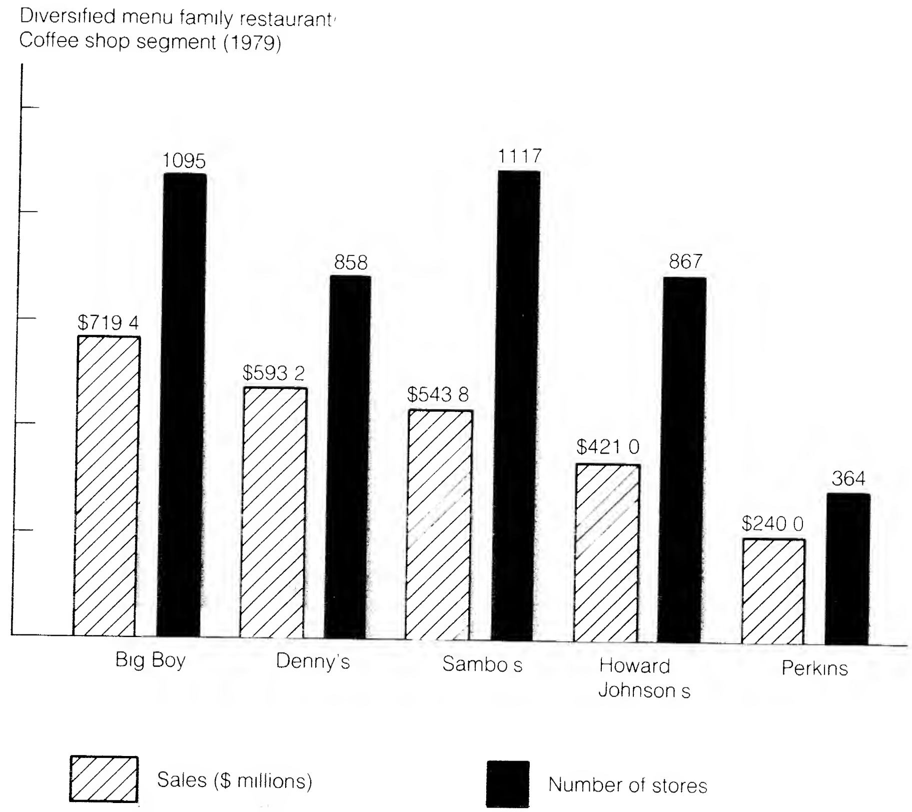
exhibit 6
Perkins' food and labor costs as a percent of sales

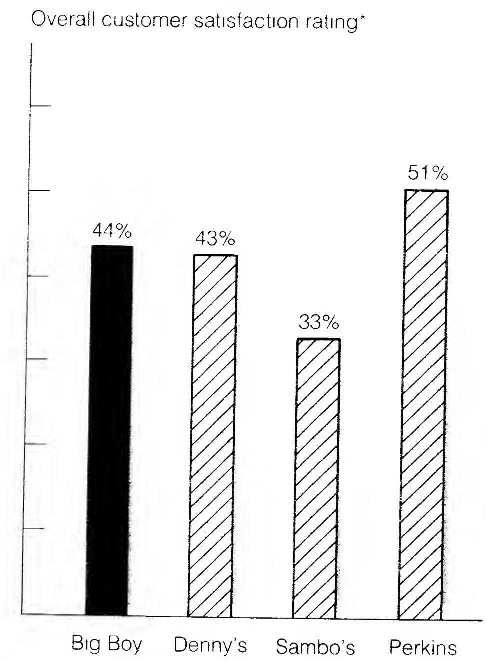


28 In general, there is no clear nationwide leader among family restaurant chains. In 1980 Perkins system sales represented 10 percent of the total sales generated by the five largest family restaurant chains. In the family restaurant category in which it competes, Perkins is fifth in sales as shown in Exhibit 7.

29 Perkins continues to place significant emphasis on its franchising operations. During 1980 the number of franchise field representatives who offer marketing and operational support was quadrupled. In addition, 16 marginal franchised units were removed from the system and replaced with 15 new and more profitable units to further upgrade the quality of franchised operations. Perkins expects to add 10–15 new franchised units in 1981, with an even greater emphasis on franchising in later years as operations and controls improve.

exhibit 7
Family restaurant industry





* Based on excellent or very good responses to the following question. "Overall, how would you rate this restaurant? That is, would you say it is excellent, very good, good, fair, or poor?" From July 1980, restaurant customer satisfaction study, in selected markets where these companies compete, conducted by Burke Marketing Research Inc.

Source: Institutions Magazine.

Steamship group

30 Delta Steamship Lines, Inc.'s operating income almost tripled in 1980 to a record $47.8 million on a 35.6 percent revenue increase. (See Exhibit 12.)

31 This dramatic improvement was brought about in large part by a new management team. Fifty percent of the subsidiary's top 28 positions were filled by people new to the company within the past 24 months. This revitalized management successfully instituted a number of marketing and operational programs in late 1979 which contributed greatly to the 1980 improvement.

32 Revenue tons increased by 15.4 percent in 1980 through fleet redeployment to trade routes that best utilized each vessel's capabilities. Better scheduling permitted a 6.8 percent improvement in completed voyages. This allowed increased frequency of port calls, a factor important to shippers and their customers. Fifty percent more containers for better cargo handling and inexpensive hardward modifications allowed Delta to provide more container equipment to customers while reducing its unit costs through this expended LASH technology as well as favorable lease arrangements.

33 Having become the major U.S.-flag carrier out of U.S. Gulf ports, Delta actively competes with the national flag lines of most of the 50 countries in the Caribbean, South America, and the West Coast of Africa that it serves. In a trade where these foreign carriers receive direct and indirect government support, Delta's growth has continued "mainly from improved service coupled with enhanced marketing and operational programs applied to an expanded fleet," according to Holiday Inn management.[6]

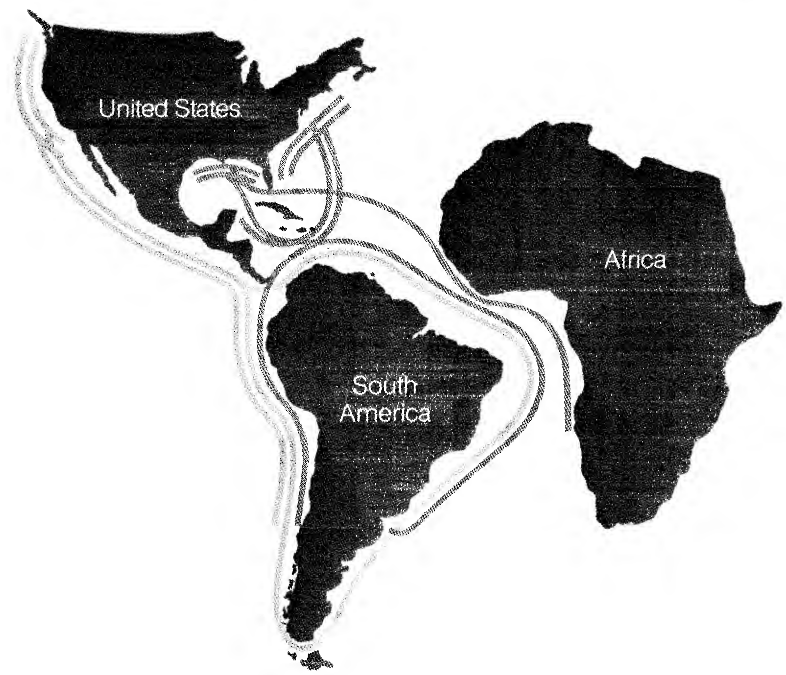
34 In general, the diversity of countries (see Exhibit 8) Delta serves and the ambitious expansion programs under way in many of them bode well for the future of Delta. Apart from fuel costs, the fleet is relatively inexpensive to maintain and operate and is sufficiently flexible to meet customer shipping demands.

35 While Delta's performance has improved dramatically, it remains the only business within Holiday Inns, Inc.'s portfolio that is not consistent with its business definition for the 1980s—a hospitality company. Commenting on this, Winegardner offered the following:

> We recognize that Delta does not fit Holiday Inns' long-term objective of being a hospitality company, although it did clearly establish for itself in 1980 an important role in the execution of our hospitality strategy. With its improved performance, Delta provides significant cash flow to fund invest-

[6] Holiday Inns, Inc.'s steamship subsidiary Delta Steamship Lines, Inc. (Delta), operates under operating differential subsidy agreements (expiring in 1995 and 1997) in which the United States Maritime Administration compensates Delta for portions of certain vessel operating expenses that are in excess of those incurred by its foreign competitors. The subsidy recorded in 1980, 1979, and 1978 amounted to $60,419,000, $52,429,000, and $33,666,000, respectively.

exhibit 8
Delta trade routes



ment in our hospitality businesses. As a result, Delta has earned an important position in our plans to maintain leadership in the hospitality industry.

Positioning for the 1980s

36 With the exception of the Delta Steamship operation, Holiday Inns, Inc. has rapidly positioned itself as a pure hospitality company for the decade of the 1980s. Exhibit 9 clearly illustrates the changing emphasis in terms of assets and capital expenditures between 1978 and 1980.

37 Looking to the remainder of the 1980s, Winegardner summarized Holiday Inns' corporate position:

> Our present plans do not envision further diversification in the near term, since we are well positioned in each of our industries and have significant growth opportunities within our existing lines of business. We continue, however, to seek new revenue sources without our businesses to improve returns and fully utilize our considerable management expertise.
>
> While the decade ahead promises little relief from high inflation, high cost of capital, increasingly burdensome governmental regulation, and declining productivity nationwide, we believe that Holiday Inns., Inc. will overcome these obstacles and turn them to competitive advantage.

exhibit 9
Holiday Inns, Inc.: Changing asset base ($000)

The following table reflects identifiable assets, capital expenditures, and depreciation and amortization of property and equipment for the operating segments. Capital expenditures exclude the property and equipment of purchased entities at the dates of acquisition.

	Identifiable assets	*Capital expenditures*	*Depreciation and amortization*
1980			
Hotel	$ 711,960	$122,275	$49,404
Gaming	451,075	61,209	9,618
Restaurant	97,223	10,594	4,743
Steamship	268,371	5,746	8,326
Other	151,474	7,238	2,540
Total	$1,680,103	$207,062	$74,631
1979			
Hotel	$ 650,823	$111,167	$45,070
Gaming	30,284	9	—
Restaurant	98,418	12,432	1,394
Steamship	233,485	1,411	8,087
Other	226,360	8,415	1,703
Total	$1,239,370	$133,434	$56,254
1978			
Hotel	$ 614,827	$ 92,666	$42,173
Steamship	215,864	48,787	6,431
Other	213,022	6,299	1,307
Continuing	1,043,713	147,752	49,911
Discontinued operations	99,489	21,364	13,153
Total	$1,143,202	$169,116	$63,064

exhibit 10

Summary of selected financial data

	1980	1979	1978	1977	1976	5-year compound growth rate (1975 base)	10-year compound growth rate (1970 base)
Operating results ($ millions)							
Continuing operations							
Revenues	$1,533.8	$1,112.6	$935.8	$791.4	$736.4	16.7%	14.4%
Operating income	238.1	169.3	138.1	114.2	89.8	24.4	13.9
Income before income taxes	166.6	125.1	94.5	77.6	51.6	28.6	15.0
Pretax margin	10.9%	11.2%	10.1%	9.8%	7.0%	10.2	.6
Tax rate	35.0%	43.0%	44.5%	42.1%	36.6%	(1.7)	(2.1)
Income	$108.3	$ 71.3	$ 52.5	$ 42.7*	$ 32.7	29.8	16.6
Discontinued operations—income (loss)	—	(15.4)	10.3	7.7	6.1		
Net income	108.3	55.9	62.8	50.4*	38.8	21.1	11.5
Common stock data							
Income per share—continuing	2.92	2.25	1.71	1.39*	1.07	24.9	13.7
Income (loss) per share—discontinued	—	(.49)	.33	.25	.20		
Income per share	2.92	1.76	2.04	1.64*	1.27	16.7	8.5
Cash dividends declared per share	.70	.66	.56	.465	.40	14.9	12.0
Book value per share	21.51	18.93	17.81	16.37	15.22	8.4	9.2
Price range of common stock	32½–13¾	22⅞–15¼	32¾–14⅛	16⅛–11⅛	20–10⅝		
Average number of shares outstanding ($000)	39,278	31,704	30,854	30,762	30,657	5.1	3.3
Financial position ($ millions)							
Total assets	$1,680.1	$1,239.4	$1,143.2	$987.6	$905.7	13.0	9.9
Property and equipment (net)	1,147.7	737.1	651.5	596.0	567.8	14.6	10.7
Long-term debt	564.6	311.3	301.2	288.7	276.6	12.1	6.9
Shareholders' equity	708.0	624.5	550.1	502.5	465.8	10.1	10.9
Depreciation and amortization	74.6	56.3	49.9	46.6	44.3	11.0	12.0
Capital expenditures	207.1	133.4	147.8	101.2	57.2	44.1	11.0
Current ratio	.9	1.4	1.4	1.2	1.3	(9.7)	(5.0)

exhibit 10 *(concluded)*
Summary of selected financial data

	1980	*1979*	*1978*	*1977*	*1976*	*5-year compound growth rate (1975 base)*	*10-year compound growth rate (1970 base)*
Performance measurements							
Return on sales—continuing	7.1%	6.4%	5.6%	5.7%	4.4%	11.6	2.0
Return on average invested capital	10.6	8.7†	8.5	7.8	6.4	9.3	2.5
Return on average equity	16.1	12.1†	11.9	10.9	8.6	10.4	.2
Statistical summary							
Inns at year-end							
Company	240	246	270	276	289	(4.7)	(1.8)
Licensed	1,515	1,495	1,448	1,424	1,424	1.5	4.4
Total system	1,755	1,741	1,718	1,700	1,713	.5	3.3
Rooms at year-end							
Company	56,141	55,821	58,495	58,536	58,332	(1.1)	1.3
Licensed	247,437	240,430	228,034	220,421	219,732	2.8	6.6
Total system	303,578	296,521	286,529	278,957	278,064	2.0	5.4
Occupancy	71.5%	73.8%	74.3%	71.2%	68.4%	1.8	.4
Average rate per occupied room	$36.80	$32.65	$27.81	$24.56	$22.17	12.0	9.0
Voyages completed	172	161	97	45	51	22.6	13.6
Long tons carried (000)	2,073.7	1,942.5	1,190.6	636.9	727.2	23.1	13.5

exhibit 11

HOLIDAY INNS, INC., AND CONSOLIDATED SUBSIDIARIES
Balance Sheets
For the Years 1979 and 1981
($000)

Assets	*January 2, 1981*	*December 28, 1979 (restated)*
Current assets:		
Cash	$ 35,575	$ 23,439
Temporary cash investments at cost	85,650	$ 137,774
Receivables, including notes receivable of $19,581,000 and $13,051,000, less allowance for doubtful accounts of $10,329,000 and $9,933,000	131,299	$ 115,987
Merchandise and supplies at lower of average cost or market	26,240	21,728
Deferred income taxes	16,104	11,719
Prepayments and other current assets	16,996	19,490
	311,864	330,137
Less deposits to be made to capital construction fund	40,200	7,854
Total current assets	271,664	322,283
Capital construction fund, including above deposits	50,963	7,958
Investments in nonconsolidated subsidiaries and less than majority owned affiliates	57,094	55,427
Notes receivable and other investments	64,892	62,848
Property and equipment at cost:		
Land, buildings, improvements, and equipment	1,486,298	1,023,983
Less accumulated depreciation and amortization	338,648	286,911
	1,147,650	737,072
Excess of cost over net assets of businesses acquired	56,078	30,894
Deferred charges and other assets	31,762	22,888
Total assets	$1,680,103	$1,239,370

Liabilities and Shareholders' Equity	*January 2, 1981*	*December 28, 1979 (restated)*
Current liabilities:		
Accounts payable	$ 73,899	$ 73,752
Accrued federal and state income taxes	23,106	21,157
Accrued vessel expense	33,968	19,490
Accrued insurance claims	26,343	14,374
Long-term debt due within 1 year	45,653	22,708
Other accruals and deposits	110,104	80,056
Total current liabilities	313,073	231,537
Long-term debt due after 1 year	564,613	311,302
Deferred credits	59,501	47,026
Deferred income taxes	34,955	25,014
Shareholders' equity:		
Capital stock		
Special stock: authorized 5 million shares;		
Series A: $1,125 par value; issued 650,165 and 698,854 shares; convertible into common	731	786
Common: authorized 60 million shares; $1.50 par value; issued 32,510,683 and 32,381,554 shares	48,767	48,572
Capital surplus	155,704	154,519
Retained earnings	512,802	428,020
	718,004	631,897
Capital stock in treasury at cost; 459,170 and 332,114 common shares and 72,192 Series A shares	(9,669)	(6,943)
Unissued deferred compensation shares	(374)	(463)
	707,961	624,491
Total liabilities and stockholders' equity	$1,680,103	$1,239,370

exhibit 12

HOLIDAY INNS, INC.
Summary of Income
For the Years 1978–1980
($000, except per share)

	1980	1979	1978
Revenues:			
Hotel	$ 849,036	$ 783,632	$764,930
Gaming	201,141	1,042	—
Restaurant	93,156	30,451	—
Steamship	377,143	278,069	155,004
Other	13,282	19,451	15,889
Total revenues	$1,533,758	$1,112,645	$935,823
Operating income:			
Hotel	$ 154,644	$ 137,375	$121,206
Gaming	24,111	1,042	—
Restaurant	4,261	2,931	—
Steamship	47,821	16,546	7,776
Other	7,303	11,384	9,154
Total operating income	238,140	169,278	138,136
Corporate expense	(23,344)	(17,689)	(15,317)
Interest, net of interest capitalized	(48,127)	(26,652)	(27,581)
Foreign currency translation gain (loss)	(92)	144	(717)
Income from continuing operations before income taxes	166,577	125,081	94,521
Provision for income taxes	58,302	53,785	42,017
Income from continuing operations	108,275	71,296	52,504
Discontinued operations			
Income (loss) from operations, net of income taxes	—	(270)	10,287
Loss on disposition, plus income taxes payable of $5,289,000	—	(15,141)	—
Net income	$ 108,275	$ 55,885	$ 62,791
Income (loss) per common and common equivalent share			
Continuing operations	$ 2.92	$ 2.25	$ 1.71
Discontinued operations	—	(.49)	.33
Total income (loss) per common and common equivalent share	$ 2.92	$ 1.76	$ 2.04
Average common and common equivalent shares outstanding	39,278	31,704	30,854

exhibit 13
Board of directors and officers: 1981

Board of directors

Roy E. Winegardner*†
Chairman of the board and chief executive officer
Holiday Inns, Inc.
Director since 1974

Wallace R. Bunn‡
President and chief executive officer
South Central Bell
Director since 1978

William N. Clarke
Partner
Cadwalader, Wickersham & Taft
Director since 1961

Mead Dixon
Chairman of the board
Harrah's
Director since 1980

Nicholas M. Evans‡
President
The Drackett Company
Director since 1976

Richard J. Goeglein*†
Executive vice president
Holiday Inns, Inc.
Director since 1978

R. A. Lile†‡
President and chief executive officer
Transportation Properties, Inc.
Director since 1969

Archibald McClure
Vice president, marketing
Illinois Institute of Technology
Director since 1976

Michael D. Rose*†
President
Holiday Inns, Inc.
Director since 1978

Walter J. Salmon
Stanley Roth Senior Professor of retailing, Graduate School of Business Administration
Harvard University
Director since 1981

James L. Schorr*†
Executive vice president
Holiday Inns, Inc.
Director since 1980

Arthur M. Smith, Jr.‡
Chairman of the board and chief executive officer
First National Bank of Nevada
Director since 1980

Frederick W. Smith
Chairman of the board and chief executive officer
Federal Express Corporation
Director since 1981

Charles D. Solomonson*†
Senior vice president
Holiday Inns, Inc.
Director since 1980

Ronald Terry†
Chairman of the board and chief executive officer
First Tennessee National Corporation
Director since 1979

Corporate officers

Roy E. Winegardner
Chairman of the board and chief executive officer

Michael D. Rose
President

Richard J. Goeglein
Corporate executive vice president
President and chief executive officer, Harrah's

James L. Schorr
Corporate executive vice president
President, hotel group

Edward E. Ellis
Senior vice president
General counsel and secretary

Robert B. Erskine
Senior vice president
Planning and development

William G. Layton
Senior vice president
Human resources

Charles D. Solomonson
Senior vice president
Chief financial officer

Richard T. Ashman
Vice president
Government and industry relations

Neil F. Barnhart
Vice president
Administration

Bruce F. Doane
Vice president
Internal audit

John P. FitzGerald, Jr.
Vice president
Strategic planning

Bill D. Goforth
Vice president
Communications

Robert W. Heidrich
Vice president
General counsel—hotel group

E. James House, Jr.
Vice president and treasurer

J. W. McAllister
Vice president and controller

Richard L. Nauman
Vice president
Management information services

Craig H. Norville
Vice president
Associate general counsel—corporate

James H. Rae
Vice president
Organization development

Christopher D. Whitney
Vice president
Associate general counsel-litigation

Senior officers hotel group

James L. Schorr
President
Corporate executive vice president

exhibit 13 ***(concluded)***
Board of directors and officers: 1981

Senior officers hotel group (continued)

Christopher C. Browne
Senior vice president
Marketing

Erich J. Gerner
Senior vice president
International operations

Brian A. Goodwin
Senior vice president
Personnel and industrial relations

Kenneth B. Hamlet
Senior vice president
U.S. hotel operations

Robert E. Milburn
Senior vice president
Development, planning, and finance

Daniel H. Philip
Senior vice president
Product management

Raymond E. Schultz
Senior vice president
Product services division

Senior officers gaming group

Mead Dixon
Chairman of the board, Harrah's

Richard J. Goeglein
President and chief executive officer, Harrah's
Corporate executive vice president

Romano R. Andreotti
Executive vice president
Operations

Holmes Hendricksen
Executive vice president
Entertainment

James M. Beck
Senior vice president
Management information systems

Joe Francis
Senior vice president
Operations—northern Nevada

Darrell Luery
Senior vice president
Marketing

C. G. Munson
Senior vice president
Government relations

Richard H. Wells
Senior vice president
Finance and planning

Senior officers restaurant group

Phil S. Barksdale
Senior vice president
Restaurants

McClelland Troost
President and chief executive officer
Perkins Cake & Steak, Inc.

Senior officers Delta Steamship Lines, Inc.

Andrew E. Gibson
President

Donald G. Aldridge
Senior vice president
Atlantic division

Robert E. Griffin
Senior vice president
Finance and planning

Daniel P. Kirby
Senior vice president
Gulf division

Albert B. Wenzell
Senior vice president
Pacific division

* Corporate Officer.
† Executive Committee Member.
‡ Audit Committee Member.

case 29

Days Inns of America, Inc. (A)

1 Cecil B. Day, a millionaire apartment developer from Atlanta, Georgia, sensed a void in the lodging industry while traveling with his family in New England in 1968 and to California in 1969. Full-service lodging facilities for the family with a limited travel budget did not exist. Day thought about Georgia and commented, "I realized that no one was looking out for the middle American, the guys with two, three, or four children traveling on a limited budget. Here was a need I was convinced we could fill. I noticed too that the budget chain, which had 31 units when I was on the West Coast a year before, now had 72." By 1970, the full-service, economy concept of Days Inn became a reality with the opening of the first Days Inn in Savannah Beach, Georgia.

2 The Days Inn concept of a four-in-one economy facility providing the traveler with lodging, self-service gasoline, a restaurant, and a gift shop caught on quickly. (See Exhibit 1.) Days Inns soon became the fastest-growing chain in the world, doubling in size every six months. (See Exhibit 2.) By 1978, it was ranked as the sixth largest full-service lodging chain in North America. By 1979, there were 301 Days Inns and Lodges in 27 states and Canada, providing about 43,000 rooms to the traveling public.

3 The 301 Days Inn motels are 27 percent company-owned, 60 percent franchised, and 13 percent affiliated. Days Inns projects an additional 100 franchise motel openings and 30 company or affiliate openings by 1982. The revenue dollar in fiscal 1978 was divided as shown in Exhibit 3.

The Days Inns concept

4 Cecil Day based his "budget luxury" concept on his experiences while traveling with his family in the late 60s. His concept was to offer four basic traveler services at reasonable prices. The four services—lodging, gasoline, restaurant, and gift shop—were to be of a "streamlined, no frills" quality, oriented toward the budget-conscious traveling family. Commenting on the Days Inns concept, Richard C. Kessler, president and chairman of the board of Days Inns, said: "The idea was to provide a family-oriented facility that also would serve a commercial market while offering everything we think people expect in a first class motel."

5 Days Inns continue to offer a standard, two-double-bed unit with accommodations comparable to those of higher-priced motels and hotels. Self-

This revised edition of an earlier case study was prepared by Richard Robinson, University of South Carolina, and Timothy Mescon, Arizona State University.

exhibit 1
A typical Days Inn

service gasoline at economy prices is made available at each facility. Most locations have a Tasty World restaurant that offers low-priced, standard menu items. The gift shops offer souvenir items, including some native to the particular location when appropriate. This four-in-one approach was designed to supply all the basic needs of the traveling family in one stop. Furthermore, the ability to guarantee guests gasoline on the interstates proved particularly advantageous during the oil embargo of 1974. In the process, gasoline sales have become a large business for Days Inns, as shown in Exhibit 4.

6 In order to operate profitably while charging economy prices, Days Inns had to place careful emphasis on the construction and operation costs at each Days Inn facility. Buildings were designed to minimize long-term maintenance costs and to maximize utilization of space.

exhibit 2

Locations of Days Inns and Lodges

Days Inns

Alabama:
- Bessemer
- Cullman
- Dothan
- Irondale (Birmingham)
- Mobile
- Montgomery (2)
- Opelika-Auburn
- Oxford-Anniston
- Tuscaloosa

Arizona:
- Phoenix (2)

Arkansas:
- Blytheville
- Little Rock (2)

Connecticut:
- Danbury

Florida:
- Altamonte Springs (2)
- Belle Glade—South Bay
- Bradenton
- Brooksville
- Cape Kennedy
- Clearwater
- Cocoa
- Daytona Beach (3)
- Deerfield Beach
- Ft. Lauderdale
- Ft. Myers (2)
- Ft. Walton Beach
- Gainesville
- Jacksonville (3)
- Key West
- Kissimmee (2)
- Lake City
- Lakeland
- Melbourne
- Micanopy
- Naples
- Ocala
- Orange Park
- Orlando and Clermont (9)
- Panama City
- Pensacola
- Plant City
- Pompano Beach
- Port Richey
- St. Augustine (2)
- St. Petersburg
- Sanford
- Sarasota
- Stuart
- Tallahassee (2)
- Tampa (4)
- Tarpon Springs
- Vero Beach
- West Palm Beach
- Wildwood (2)

Georgia:
- Athens
- Atlanta (7)
- Augusta
- Brunswick
- Calhoun
- Cartersville
- Cordele
- Forsyth (2)
- Gainesville
- Griffin
- Hahira (Valdosta)
- Harbor Village (north Brunswick)
- Macon
- McDonough
- Milledgeville
- Oglethorpe Mall (Savannah)
- Richmond Hill
- Ringgold (Chattanooga)
- Savannah Beach
- Suwannee
- Thomasville
- Tifton (2)
- Unadilla (2)
- Warner Robins
- Waycross

Illinois:
- Effingham
- Peoria
- Mattoon
- Quincy (under construction)
- Springfield

Indiana:
- Elkhart
- Ft. Wayne
- Indianapolis (2)
- Jeffersonville (Louisville, Ky.)
- Kokomo
- Remington
- Sellersburg (Louisville, Ky.)
- Seymour
- South Bend

Iowa:
- Clear Lake

Kansas:
- Lenexa (Kansas City)

Kentucky:
- Bowling Green
- Corbin
- Elizabethtown
- Frankfort
- Georgetown
- LaGrange
- Lexington
- Mt. Sterling
- Owensboro
- Paducah
- Richmond
- Richwood (Cincinnati, Ohio)
- Shepherdsville

Louisiana:
- Baton Rouge
- Bossier City
- Lake Charles
- New Orleans (2)
- Shreveport

Maryland:
- Salisbury
- Williamsport

Massachusetts:
- Worcester

Michigan:
- Gaylord
- Holland
- Muskegon
- Traverse City

Mississippi:
- Grenada
- Hattiesburg
- Jackson (2)
- Jackson #3
- Meridian
- Natchez
- Sardis

Missouri:
- St. Louis

Nebraska:
- Lincoln

New Mexico:
- Albuquerque

North Carolina:
- Asheville (3)
- Benson
- Charlotte (3)
- Concord
- Durham
- Fayetteville
- Gastonia
- Goldsboro
- Greensboro
- Henderson
- Lumberton
- Morganton
- Raleigh (under construction)

exhibit 2 ***(concluded)***
Locations of Days Inns and Lodges

Rocky Mount
Rowland
Salisbury
Selma
Statesville
Wilmington

Ohio:
Akron-Medina
Cincinnati (4)
Columbus (2)
Dayton (3)
Jeffersonville
Lima
Monroe
Sandusky
Sidney
Toledo-Perrysburg
Youngstown (2)

Oklahoma:
Oklahoma City (2)
Tulsa

Pennsylvania:
Allentown
Harrisburg

South Carolina:
Anderson
Charleston
Charleston #2 (under construction)
Columbia
Dillon
Florence
Greenville
Hardeeville
Manning
Santee
Spartanburg

Tennessee:
Chattanooga
Cookeville
Jackson
Jellico
Knoxville (2)
Lebanon
Manchester
Memphis (3)
Murfreesboro
Nashville (4)

Texas:
Beaumont
Dallas (9)
Ft. Worth (2)
Harlingen
Houston (4)
San Antonio (2)

Virginia:
Alexandria
Ashland
Carmel Church
Chester
Christiansburg
Emporia
Fredericksburg
Lexington
Petersburg
Richmond
Roanoke
Staunton
Williamsburg

West Virginia:
Parkersburg

Canada:
Cambridge, Ontario

Total Days Inns—273

Days Lodges

Alabama:
Montgomery

Florida:
Altamonte Springs
Englewood
Gainesville
Hobe Sound
Jacksonville
Key West
Kissimmee
Lake City
Naples
Orlando
Panama City
Port Richey
Tarpon Springs
Wildwood

Georgia:
Atlanta (6)
Cartersville
Forsyth
Gainesville
Tifton

Louisiana:
New Orleans

Massachusetts:
Worcester

North Carolina:
Charlotte

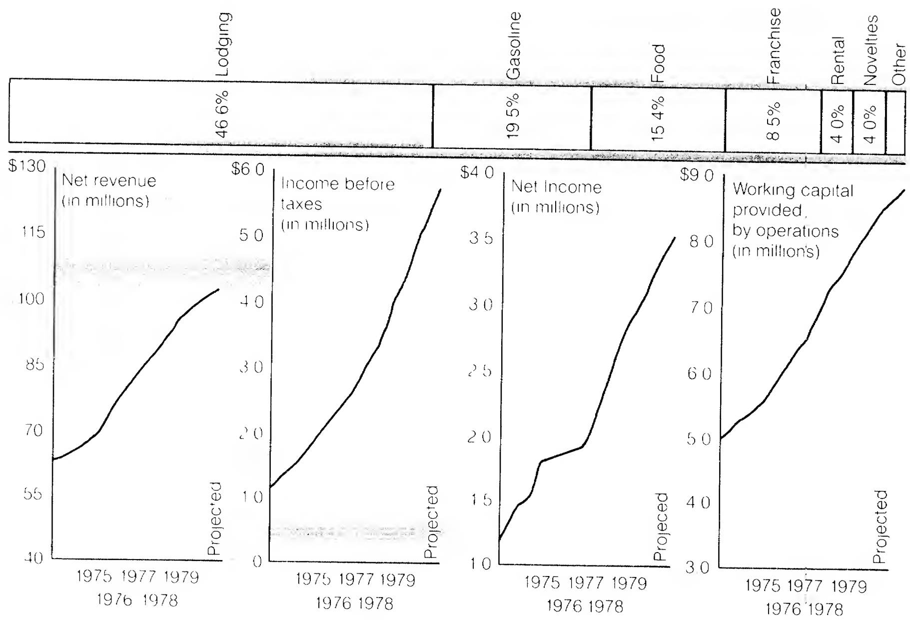
South Carolina:
Anderson

Tennessee:
Chattanooga
Nashville

Virginia:
Chester

Total Days Lodges—32

exhibit 3
Revenue dollar, fiscal 178



Top management

Cecil B. Day, Sr.—founder

7 Born the son of a rural Georgia Baptist minister in 1934, Cecil Day grew up in Savannah, Georgia, and Macon, Georgia. As a high school student he worked in his uncle's real estate office during the afternoons to help support his family after the death of his father. Day later worked full time for a

exhibit 4
Gasoline statistics

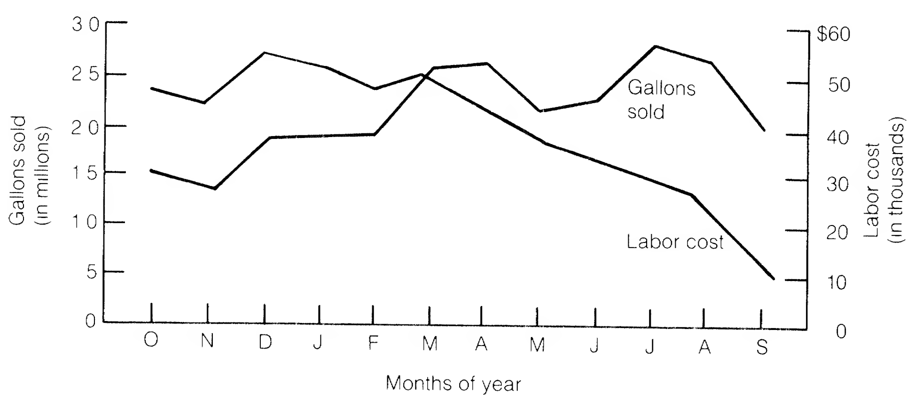
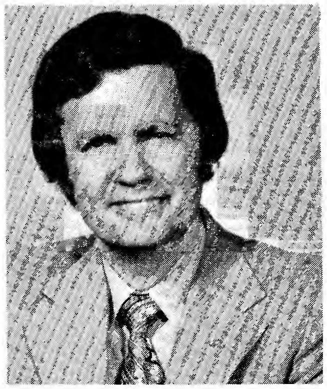
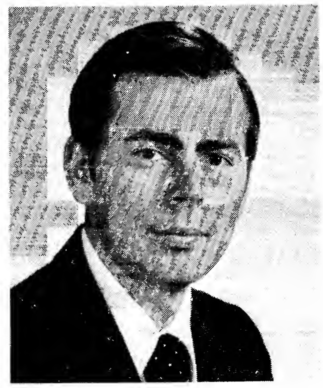


exhibit 5



A. Cecil Day



B. Richard Kessler

heating and air conditioning company while attending Georgia Tech as a full-time student. After graduating in 1958, he soon became involved in the real estate business as a salesperson with an Atlanta-area realty company.

8 By 1962, Day had established his own realty company, Day Realty Associates, Inc., in Atlanta. In the years following its establishment, the company concentrated on building and operating apartments, amassing nearly 2,000 units, in addition to investing in other properties. In 1970, the company closed one of the largest sales ever in the southeastern real estate market—selling the majority of its apartment properties for over $13 million. The profits from that sale provided the financial base for the development and expansion of Days Inns.

9 Christian service was an important part of Cecil Day's life. He created a chaplain service as a corporate division of Days Inns of America, Inc. When a member of Gideons International complained to Day at a motel opening about guests stealing Bibles, Day responded, "Who needs a Bible more than a person who steals one?" Day started a program encouraging guests to take Bibles from Days Inns rooms, and by 1977 he had distributed over 1 million Bibles. Day's philosophy of combining sound business practices with Christian service is prominent throughout the company. Not only is Days Inns one of the few corporate tithers in history; it also extends personal chaplain services to guests and employees through its chaplain services division.

10 In 1979, Days Inns looked forward to a good future, but on a sad note. In December 1978, at age 44, Cecil Day died of cancer. In a statement to the *Altanta Constitution,* Richard Kessler said:

> Day was an inspiration to all of us in the Day companies as a man of integrity, sincerity, and courage. We will continue to operate under the Christian principles Day established, and maintain the corporate objectives he planned.

Richard C. Kessler, chairman of the board

11 At age 33, Richard C. Kessler is the youngest president, chief executive officer, and chairman of the board of a major motel chain in the lodging industry today. His meteoric rise to the top of Days Inns of America, Inc., is indicative of his perseverance and abilities.

12 In 1964, Kessler, a native of Savannah, Georgia, moved to Atlanta, where he attended the Georgia Institute of Technology. In 1969, he graduated with a bachelor's degree in industrial engineering, and in 1970 he received a master of science degree. Immediately following his graduate work, Kessler joined Cecil B. Day, Sr., as an assistant in charge of construction development of Days Inns.

13 From 1970 to September 1978, when he was appointed president, chief executive officer, and vice chairman of the board, Kessler held a variety of positions within Day's diverse operations. He developed Day Realty operations in Orlando, Florida; Savannah and Albany, Georiga; Charleston, South Carolina; Denver, Colorado; and Richmond, Virginia. Each realty operation concentrates on site acquisition, financing, and the construction of motels and apartments. In May of 1975 Kessler became chief financial officer and vice chairman of the board, assuming leadership responsibility for the entire Days Inns operations.

Robert C. Bush, administration

14 Robert Bush currently serves as senior executive vice president and chief administrative officer of Days Inns. He joined the Day organization in 1972 as vice president of Day Realty of Orlando, Florida. Bush graduated from Georiga Tech in 1967 with a degree in civil engineering. He served two years as an officer in the U.S. Navy.

H. Douglas McClain, operations

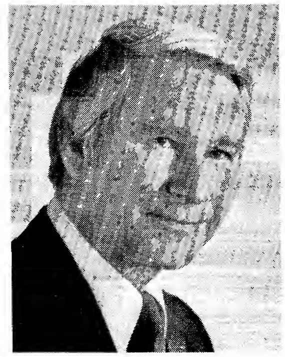
15 H. Douglas McClain joined the Days Inns organization in 1972 as special assistant to C.B. Day. Prior to joining Days Inns, McClain served as director of merchandising and sales as well as director of store planning and development for F. W. Woolworth Co. McClain attended Auburn University, where he majored in business administration. Before assuming his current position as executive vice president for field operations, McClain served in several executive positions within the operations division.

Kenneth Niemann, finance

16 Kenneth Niemann, executive vice president and chief financial officer for Days Inns, was formerly with Price, Waterhouse & Company, as well as a

exhibit 6

A. Robert C. Bush

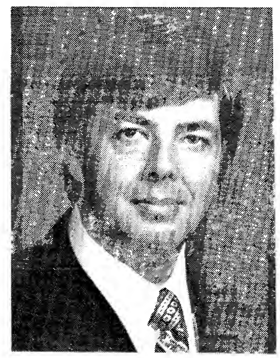


B. H. Douglas McClain

C. Kenneth Niemann

D. William B. Hargett

E. James D. Landon



F. Roy B. Burnette

mortgage investment firm. A 1964 graduate of Kent State University in business administration and a CPA, Niemann joined Days Inns as corporate controller in the early 1970s.

William B. Hargett, franchise sales

17 William B. Hargett is senior vice president for franchise sales and development at Days Inns. A graduate of Georgia Tech and the Wharton School with an MBA, Hargett is responsible for future growth through franchise sales.

James D. Landon, franchise operations

18 Working closely with Bush is James D. Landon. Landon, senior vice president for franchise operations, is responsible for the operations of Days Inns

franchises. Formerly with the Howard Johnson company, Landon joined Days Inns as franchise director in 1973. At that time, there were 14 franchise properties. By 1979 there were more than 180 franchises. Landon is a 1955 graduate of Purdue University.

Roy B. Burnette, marketing

19 Roy Burnette joined the Day organization in 1973 as vice president for operations for Day Realty of Orlando, Florida. A 1967 graduate of Georgia Tech (mechanical engineering), he served as an officer in the U.S. Air Force from 1968 until 1973. Burnette is currently senior vice president for marketing and sales.

David B. Workman, human resources

20 A recent addition to the executive management of Days Inns is David B. Workman. Workman is senior vice president of manpower development. Coming to Days Inns from a similar position with Walt Disney World, Workman represents Richard Kessler's increased emphasis on human resource development within the Days Inns organization.

21 In his search for executive talent, Kessler emphasized such requirements as the need for "experienced, but growing managers" and "good long-term potential." He stressed that "Days Inns is creative and progressive; always looking for a better way to do it."

Organization at Days Inns

22 Exhibit 7 is an organization chart of Days Inns. A brief description of each of the functional areas should provide some helpful insight into the operations of Days Inns.

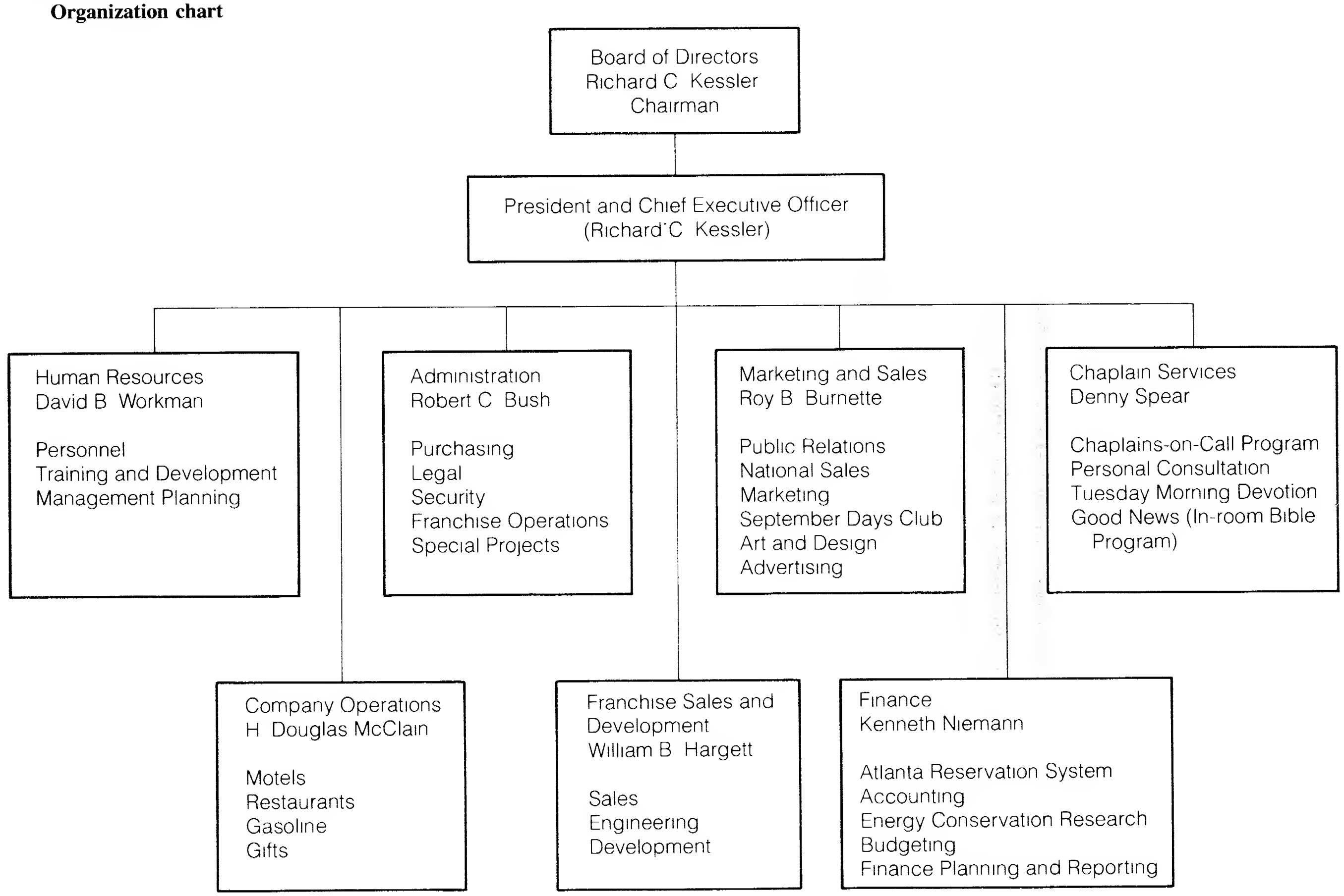
Administration

23 This department provides key support functions for company and franchise operations. Most purchasing activities are coordinated through this department. Legal services and support are centralized here. Security for Days Inns, as well as special projects, is coordinated through administration. Another major role in this department is to oversee the operation of franchisees.

Operations

24 The operations department is responsible for overseeing all motel, gasoline, restaurant, and gift shop operations.

exhibit 7
Organization chart



Franchise

25 At the end of 1977, franchise owners operated more than 180 Days Inns and Lodges, extending from Massachusetts to Florida and westward to Arizona. In July 1977, the first international property opened in Cambridge, Ontario, Canada.

26 Recently, the quality assurance function of this department was expanded to provide an in-depth evaluation of each property every three months. Coinciding with this plan was the creation of the 450 Club. Membership in this club is conferred upon owners where properties score at least 450 out of a possible 500 points on quality assurance evaluations for four consecutive quarters.

Finance

27 The current emphasis in the financial department is on planning. A recently installed medium computer system helps compile daily statistical information from all motels. Within 24 hours of the close of each business day, concise information is received on occupancy percentages; daily cash deposits; restaurant, gift, and gasoline sales; and labor data. The financial department also prepares a five-year corporate forecast and budget, which may be modified quarterly by the company's budget committee and operating personnel.

Chaplain services and general department

28 Days Inns of America, Inc. has a program to assist its customers and offer them more than food or lodging. The company enlists a local clergyman for each motel whose counsel and services are available to the guests. The clergyman's name and phone number are placed in each motel room, and a guest can contact him (referred to as Chaplain on Call) at any hour of the day or night.

29 At present over 200 clergymen serve in this voluntary capacity—a network of caring expressed in personal response to human needs. Supervising this extensive program are staff chaplains operating from the home office and functioning as an integral part of the Days Inns parent company. In addition, Days Inns has created a unique service for its employees and their families. The company maintains a department staffed by three ordained clergymen. They are available to counsel and assist employees—for example, to handle requests for personal growth experiences or to aid in facing crises.

Reservations

30 Days Inns is the only economy chain with a nationwide, toll-free reservation system in operation 24 hours a day, 7 days a week. In 1976, approximately 25

percent of Days Inns rooms were sold through the reservation system. In 1978, almost 2 million bookings were made through the reservation system, the fourth-highest volume in the industry. (See Exhibit 8.)

31 Another first for the Days Inns chain is that it now pays travel agents commission on individual bookings. By using Days Inns Travel Agent Nite-Check (TANC), a travel agent can earn a 10 percent commission for all bookings, from individual room-nights to conventions.

Marketing

32 The marketing department encompasses a wide range of functions, including sales, general and outdoor advertising, public relations, and customer relations. Days Inns has been recognized as a marketing innovator in the motel industry. One highly successful marketing strategy was September Days Club, which is discussed in a subsequent section. Some of the key parts of Days Inns' marketing strategy include the following.

33 **Pricing strategy** Days Inns' strategy has been to offer comfortable accommodations to the traveling public at economical rates. By streamlining operational costs, eliminating frills, and standardizing facilities, Days Inns is able to charge prices substantially below those of most competitors and to maintain a profitable, growing operation.

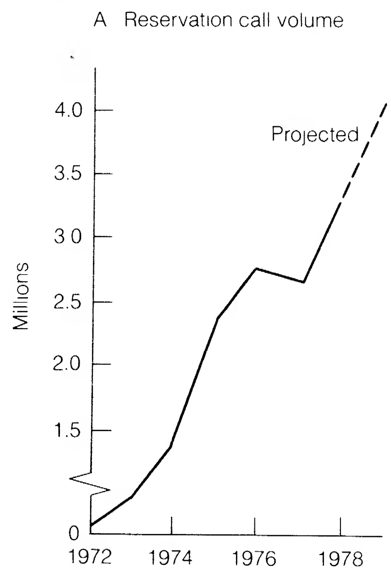
34 **Advertising** Days Inns has followed a strategy of innovative advertising aimed at selected, budget-conscious market segments, such as families and retired people. Its billboard advertising is standardized by format and color scheme for all properties (company-owned and franchises). A considerable amount of advertising is directed toward travel agents with the Travel Agent Nite-Check program. In fiscal 1978, Days Inns selectively distributed 6 million Days Inns directories, effectively reaching key market segments. Advertising emphasis on Days Inns' reservation system was partly responsible for $80 million in room, food, and other sales.

September Days Club

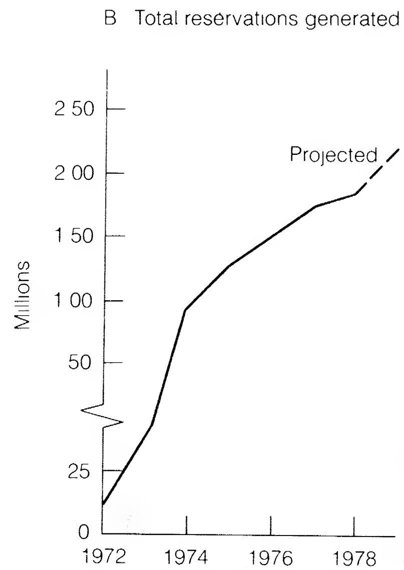
35 If necessity is the mother of invention, the 1974 recession turned out to be about the best mother Days Inns could have asked for. The business slump of 1974 led Days Inns to create the September Days Club (SC) as a way of "thanking the senior citizens who contributed so much to the success of the motel chain." *Lodging* magazine, the official publication of the American Hotel and Motel Association, offered this July 1977 observation of Days Inns's thankful gesture:

> What that meant in marketing language was to invite any of 44 million Americans over 55 to accept a free membership in a club entitling them to 10 percent discounts in food and lodging at 270 Days Inns across the United States.

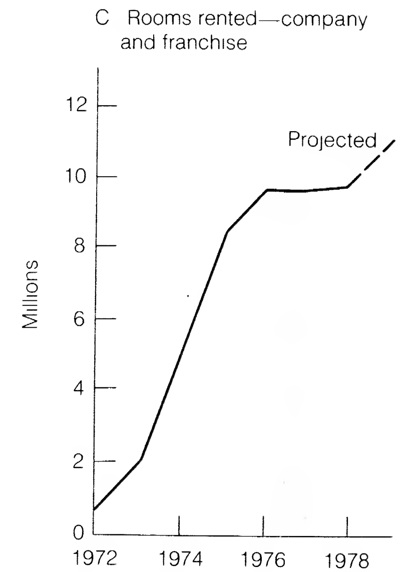
exhibit 8



A. Reservation call volume



B. Total reservations generated



C. Rooms rented—company and franchise

36 Originally, this 10 percent discount applied to the month of September, a perennial low-occupancy month in the motel industry. Because of an overwhelming response, the SDC concept was extended to a year-round program. The September Days Club is the first and only club in the lodging industry for persons 55 years of age and over. It is also the only lodging industry club to offer discounts to senior citizens on food and gifts, as well as lodging. Initially, membership was free, but now there is a charge of $5 per year (per individual or per couple). The membership fee entitles the member to a quarterly magazine (*September Days*), reduced rates at rental car agencies, discounts at various theme parks and attractions, and attendance at national and regional SDC conventions, as well as the 10 percent Days Inns discount.

37 SDC now has approximately one-half million members, and the average growth rate is 20,000 new members per month. SDC members now account for 15 to 20 percent of the total Days Inns occupancy, even during the peak travel season. There were 15 SDC conventions in 1978, booking all available Days Inns rooms at the various convention sites. In 1975, SDC was made a department in Days Inns, and Tom C. Lawler was appointed as director. Lawler had this to say about SDC members:

> They take good care of our rooms, and they travel most often in couples, and usually in the spring and fall off-season. They tend to eat where they stay, and they take advantage of their discounts by eating at a Days Inn in their home town. They are a tremendous market.

38 *Lodging* magazine underscored Lawler's remarks with the following observation:

> Days Inns has done a brilliant job of tapping the *biggest* hotel/motel market in America and perceiving its special needs and dreams. It has provided one more proof that the markets are there—for innkeepers perceptive enough to identify these, and aggressive enough to "reach out" for them. And, creative enough to cultivate them and make them grow.

Operations

39 To minimize costs, Days Inns were built using componentized wood-frame and masonry construction. Most rooms open to the outside, except in colder climates, where interior corridors are used. Most Days Inns facilities were built according to the same 122-unit plan, as shown in Exhibit 9.

40 All rooms are exactly alike. This allows for a considerable savings on furnishings, as well as the ability to buy in volume. Most Days Inns rooms are 12 feet by 24 feet and are furnished with two doubles beds, wall-to-wall carpeting, a color television, a direct-dial telephone, and individual heating and air-conditioning units. The bathroom has a full tub, a shower, and a vanity area. (See the diagram of a typical room—Exhibit 10.) Rooms are designed to reduce cleaning time and to easily accommodate maintenance activity.

exhibit 9

A typical 122-unit Days Inn project

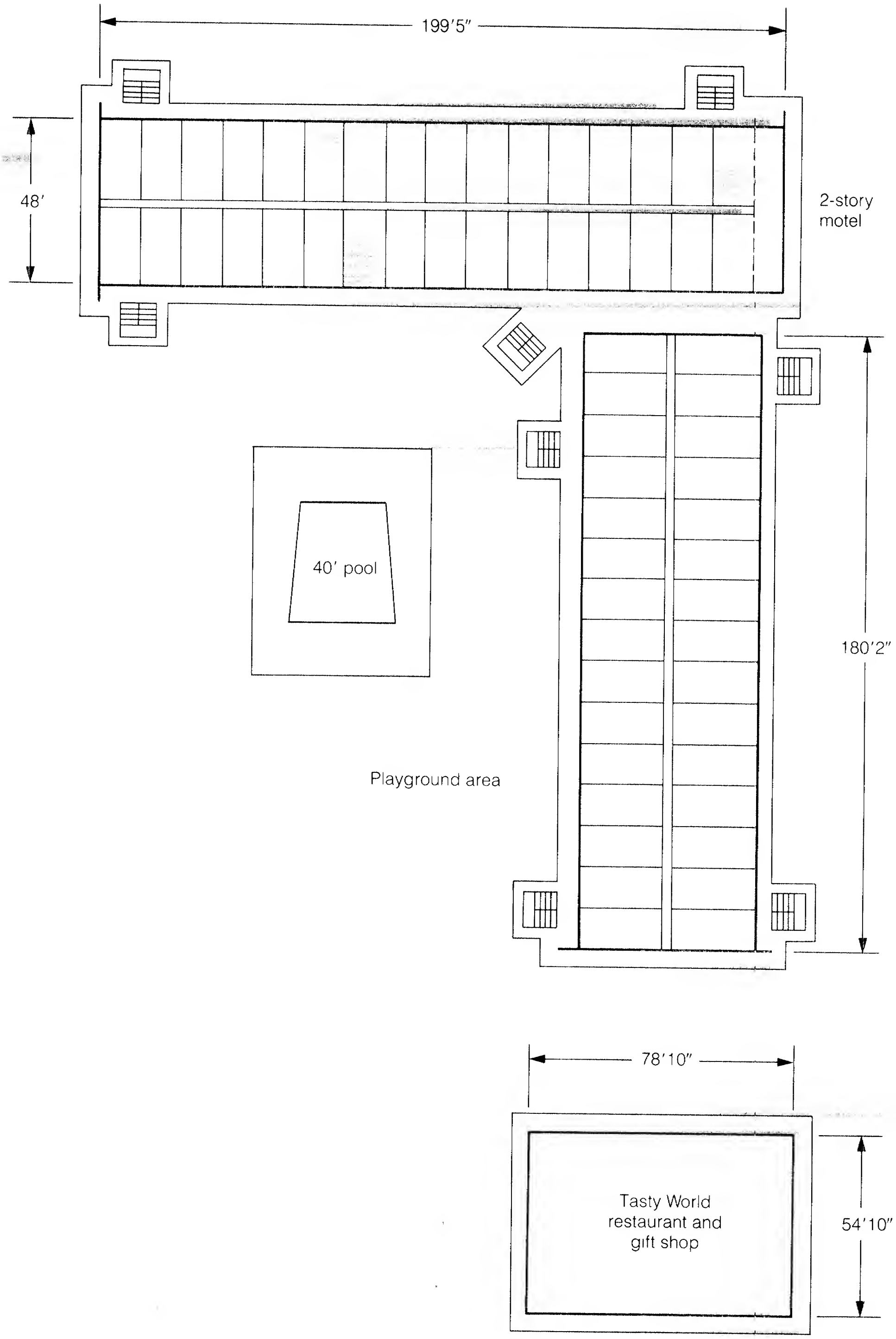
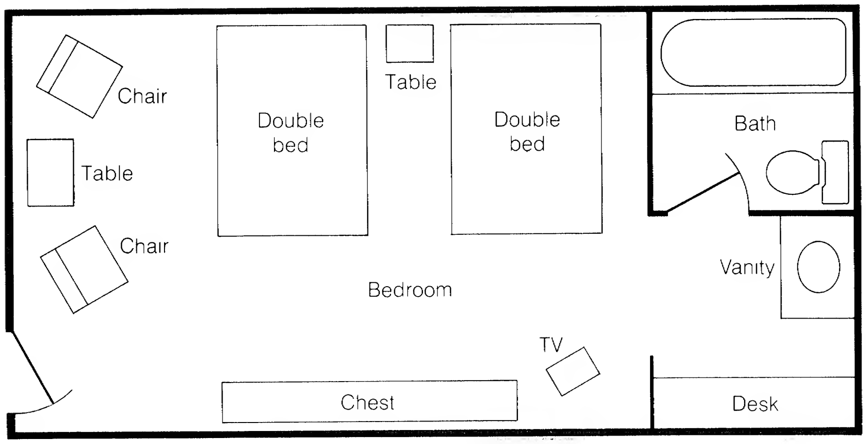


exhibit 10
A Days Inn room



41 Currently a major thrust is on updating room decor in order to implement the 1980 theme created by the interior design department. Additionally, early in fiscal 1977 the operations department initiated a series of programs designed to upgrade food services. By the end of that year, all company restaurants had installed new menus and a new decor creating "a bright, cheerful atmosphere for family dining."

42 Considerable efficiencies are obtained in the design of the restaurant/registration building. The registration desk, restaurant cashier's area, and gift shop all share the same office in the restaurant building. This cuts down on the number of employees required. There are no lobbies, no meeting or convention rooms, no cocktail lounges, no bellhops, and no room service. All payments for services (room, gas, food, gifts) are handled by one or two people at one central location. Laundry is done on the premises at most Days Inns.

43 While offering such efficiently streamlined facilities, most inns have a swimming pool, a children's playground, and a coin-operated laundry for guest use.

44 In the early 1970s, many Days Inns also offered Days Lodges facilities. Commenting on this, a Days Inns executive said:

> We discovered that many people were interested in staying at one location for several days to several weeks. So, we created Days Lodges to pick up where Days Inns left off. It is one of the best values in the lodging industry.

45 Sleeping accommodations are similar to those of the inn rooms, but there is also a kitchen, a private patio, and a living-dining area. The kitchen is completely furnished with utensils and dishes. The price is slightly higher than the price of a Days Inn room, but a Lodge suite can accommodate up to six persons.

exhibit 11
A Tasty World restaurant

Financial management

46 For a company with revenues in fiscal 1978 exceeding $94 million, the road to financial solvency was not always so smoothly paved.

47 In 1970, when the concept of Days Inns was in its infancy, financing was no easy task. Despite Cecil Day's tremendous success in the realty business, no bank would finance the construction of his first motel at Savannah Beach, Georgia. During subsequent negotiations, Day was able to obtain adequate funding at an interest rate 50 percent greater than the prime rate.

48 The steady growth in income before taxes seen over the past eight years is predicted to increase to $9.4 million by 1982. In-depth financial forecasts covering five-year periods assist management in making long-term financial investments. Kessler says that as a private company, Days Inns is "more interested in net cash flow than net income, because in our business cash pays the bills and can be reinvested in existing properties and new ventures; whereas, a public company is typically more concerned about showing large earnings to boost stock sales."

49 At this juncture, cash flow and net income appear to be plentiful for future growth.

50 Exhibits 12 through 15 present recent financial data on Days Inns.

exhibit 12

DAYS INN OF AMERICA, INC.
Balance Sheets (Historical Cost) and
Statements of Current Values
For the Years 1975–1978

	September 30, 1978	
Assets	*Current values*	*Balance sheet*
Current assets:		
Cash (restricted)	$ 92,000	$ 92,000
Certificates of deposit	3,003,000	3,003,000
Accounts and notes receivable net of allowance for doubtful accounts of $927,000 and $897,000		
Affiliated companies	186,000	186,000
Nonaffiliated franchisees	1,504,000	1,504,000
Debenture from sale of Canadian franchise		
Other	816,000	816,000
Retail inventories and supplies	1,484,000	1,484,000
Prepaid expenses	637,000	637,000
Total current assets	7,722,000	7,722,000
Property and equipment	81,149,000	56,750,000
Less: Accumulated depreciation		(18,984,000)
Accounts and notes receivable:		
Stockholders and affiliated companies	4,821,000	4,821,000
Debentures from sale of Canadian franchise		
Nonaffiliated franchisees and other	346,000	346,000
Franchise agreements	15,500,000	
Deferred charges	802,000	802,000
Accumulated income tax prepayments	127,000	127,000
Other assets	58,000	58,000
Total assets	$110,525,000	$51,642,000
Liabilities and Stockholders' Equity		
Current liabilities:		
Notes payable	$ 3,728,000	$ 3,838,000
Accounts payable	3,078,000	3,078,000
Accrued expenses and other liabilities	2,802,000	2,802,000
Income taxes payable	722,000	722,000
Total current liabilities	10,330,000	10,440,000
Notes payable, due after one year	32,578,000	34,157,000
Accounts and notes payable to stockholders and affiliated companies, due after one year	1,520,000	1,520,000
Deferred income taxes		
Income taxes on realization of estimated current values	17,900,000	
Real estate commissions on realization of estimated current values	2,900,000	
Accrued rent		
Deferred income and deposits	868,000	868,000
Stockholders' equity:		
Common stock, without par value—1 million shares authorized 341,670 shares issued	59,000	59,000
Capital surplus	949,000	949,000
Retained earnings	4,590,000	4,590,000
Unrealized appreciation	39,772,000	
	45,370,000	5,598,000
Less: Treasury stock, at cost—19,320 and 6,000 shares	941,000	941,000
Total stockholders' equity	44,429,000	4,657,000
Commitments and contingent liabilities		
Total liabilities and stockholders' equity	$110,525,000	$51,642,000

September 30, 1977		*Current values only*	
Current values	*Balance sheet*	*September 30, 1976*	*September 30, 1975*
$ 86,000	$ 86,000	$ 98,032	$ 198,638
576,000	576,000	1,128,136	1,929,129
593,000	593,000		
1,156,000	1,156,000	967,599	421,905
			472,500
530,000	530,000	328,924	418,778
1,742,000	1,742,000	1,749,270	1,145,897
930,000	930,000	1,329,321	1,582,074
5,613,000	5,613,000	5,601,282	6,168,921
65,354,000	52,253,000	47,885,980	37,530,021
	(14,002,000)	(9,312,771)	(6,240,523)
4,867,000	4,867,000	4,852,311	4,722,874
			450,000
300,000	300,000	258,095	7,791
13,000,000			
1,101,000	1,101,000	1,274,688	1,001,006
			654,000
170,000	170,000	159,465	207,691
$90,405,000	$50,302,000	$50,719,050	$44,501,781
$ 4,221,000	$ 4,263,000	$ 5,667,410	$ 4,317,669
2,543,000	2,543,000	3,107,490	2,955,837
2,249,000	2,249,000	2,392,185	2,263,595
405,000	405,000	302,955	510,091
9,418,000	9,460,000	11,470,040	10,047,192
35,008,000	35,456,000	35,272,010	33,385,353
2,114,000	2,114,000	2,756,093	184,080
68,000	68,000	150,000	—
12,600,000			
2,350,000			
			3,535,261
740,000	740,000	459,884	1,638,362
59,000	59,000	58,982	58,982
949,000	949,000	552,041	
1,870,000	1,870,000		(4,347,449)
25,643,000			
28,521,000	2,878,000		
414,000	414,000		
28,107,000	2,464,000	611,023	(4,288,467)
$90,405,000	$50,302,000	$50,719,050	$44,501,781

exhibit 13

DAYS INN OF AMERICA, INC.
Statements of Income
For the Years Ended September 30, 1975–1978

	1978	*1977*	*1976*	*1975*
Net revenue:				
Lodging	$44,242,000	$38,948,000	$35,411,582	$33,501,838
Food, gasoline and novelties	36,896,000	31,047,000	22,543,688	18,305,516
Franchise fees—initial	337,000	263,000	250,278	1,014,212
Sale of Canadian franchise				1,000,000
Recurring	7,757,000	6,436,000	5,711,553	4,829,803
Rental income	3,766,000	3,651,000	3,491,940	3,346,869
Other income	1,885,000	1,151,000	723,870	698,504
Total revenues	94,883,000	81,496,000	68,132,911	62,696,742
Costs and expenses:				
Cost of food, gasoline, and novelties	25,234,000	20,397,000	12,029,405	8,520,454
Selling, general, administrative, and operating expenses	46,587,000	39,446,000	35,236,142	33,134,496
Rental expense—motel and restaurant leases				
Rent paid	10,197,000	10,555,000	11,312,844	11,631,457
Rent accrued			1,167,600	1,308,834
Depreciation and amortization of property and equipment	5,309,000	4,851,000	3,142,719	2,847,663
Interest expense, net of interest income of $523,004 and $301,573	3,476,000	3,642,000	3,389,574	3,446,297
Loss on disposal of real estate				729,701
Total expenses	90,803,000	78,891,000	66,278,284	61,618,902
Income before provision for income taxes and extraordinary item	4,080,000	2,605,000	1,854,627	1,077,840
Provision for income taxes	1,260,000	725,000	538,000	378,000
Income before extraordinary item			1,316,627	699,840
Extraordinary item:				
Tax benefit from utilization of loss carryforward			488,000	354,000
Net income	$ 2,820,000	$ 1,880,000	$ 1,804,627	$ 1,053,840

exhibit 14
Statements of stockholders' equity (accumulated capital deficit)

	Common stock	*Treasury stock*	*Capital surplus*	*Retained earnings (accumulated deficit)*	*Total*
Balance—September 30, 1975	$59,000			$(4,348,000)	$(4,289,000)
Net income				1,805,000	1,805,000
Capital surplus arising from the transaction with Cecil B. Day, Sr.			$ 3,095,000		3,095,000
Restatement of capital accounts			(2,543,000)	2,543,000	
Balance—September 30, 1976	59,000		552,000		611,000
Net income				2,277,000	2,277,000
Purchase of treasury stock		$(414,000)			(414,000)
Cash dividends				(10,000)	(10,000)
Balance—September 30, 1977	$59,000	$(414,000)	$ 552,000	$ 2,267,000	$ 2,464,000

exhibit 15

DAYS INN OF AMERICA, INC.
Statements of Changes in Financial Position
For the Years Ended September 30, 1975–1978

	1978	*1977*	*1976*	*1975*
Financial resources were provided by:				
Operations:				
Income before extraordinary item	$ 2,820,000	$ 1,880,000	$ 1,316,627	$ 699,840
Add income charges (credits) not affecting working capital:				
Depreciation and amortization	5,309,000	4,851,000	3,142,719	2,847,663
Accrued rent			1,167,600	1,308,834
Deferred income taxes	(195,000)	(82,000)	(296,000)	(654,000)
Loss on disposal of real estate				729,701
Amortization of deferred charges	78,000	92,000	128,012	89,213
Working capital provided by operations before extraordinary item	8,012,000	6,741,000	5,458,958	5,021,251
Utilization of loss carryforward		397,000	488,000	354,000
Increases in notes payable	1,681,000	1,604,000	10,737,736	10,561,144
Debentures from sale of Canadian franchise			450,000	
Increase in deferred income—franchise fees	330,000	2,674,000		158,098
Contributed capital	176,000	109,000	3,094,863	
Sale of property and equipment	174,000	280,000	48,461	1,601,371
Decrease in other assets	251,000		48,226	141,569
Total working capital provided	10,624,000	11,805,000	20,326,244	17,837,433
Financial resources were used for:				
Reductions of notes payable	3,904,000	4,736,000	6,279,066	4,121,482
Acquisition of property and equipment	4,588,000	1,882,000	10,474,891	2,482,278
Debentures from sale of Canadian franchise				450,000
Increase in receivables from stockholders and affiliated companies		15,000	129,437	1,444,260
Increase in other receivables or assets	46,000	52,000	250,304	7,791
Accrued rent net of related deferred income taxes			3,602,861	
Increase in deferred charges			401,694	19,250
Decrease in deferred income—franchise fees			1,178,478	
Capitalization of leases	330,000	2,674,000		
Purchase of treasury stock	527,000	414,000		
Cash dividends	100,000	10,000		
Total working capital used	9,495,000	9,783,000	22,316,731	8,525,061
(Decrease) increase in working capital	$ 1,129,000	$ 2,022,000	$(1,990,487)	$ 9,312,372

exhibit 15 ***(concluded)***

	1978	*1977*	*1976*	*1975*
Analysis of changes in working capital:				
Increase (decrease) in current assets:				
Cash	$ 6,000	$ (12,000)	$ (100,606)	$ (34,532)
Certificates of deposit	2,427,000	(552,000)	(800,993)	1,872,129
Accounts and notes receivable:				
Nonaffiliated franchisees	348,000	188,000	545,694	(34,285)
Debenture from sale of Canadian franchise			(472,500)	472,500
Affiliated companies	(407,000)	593,000		
Others	286,000	201,000	(89,854)	(431,999)
Retail inventories and supplies	(258,000)	(7,000)	603,373	(660,312)
Prepaid expenses	(293,000)	(399,000)	(252,753)	704,638
(Increase) decrease in current liabilities:				
Notes payable	425,000	1,405,000	(1,349,741)	7,407,181
Accounts payable	(535,000)	564,000	(151,653)	1,231,673
Accrued expenses and other liabilities	(553,000)	143,000	(128,590)	(704,530)
Income taxes payable	(317,000)	(102,000)	207,136	(510,091)
(Decrease) increase in working capital	$1,129,000	$2,022,000	$(1,990,487)	$9,312,372

Personnel policies

51 In January 1977, Days Inns opened its management training center. According to the 1977 annual report:

> The concept has been a novel one: the conversion of a busy full-service property, with rooms, gift shop, restaurant, and gasoline facilities, into a training center. Thus, management candidates receive instruction, perform, and live in an actual working environment for 3–6 weeks. Candidates perform all operational tasks including cooking and serving food, busing tables, room cleaning, laundering, front desk operations, and night auditing.
>
> The concept has been expanded to make the property an experimental center for the testing of new products, techniques, and procedures. This action benefits the candidates directly, since they enter their first career assignments proficient in the applications of Days Inns' latest programs.

52 Days Inns has established a multilevel employee development program, which is coordinated by the training department. Essentially a career planning/development tool, the employee development program helps employees develop personal guidelines for more rewarding Days Inns careers. The program is aimed at all levels of employees. To identify and ensure top management resources for the future, the department has the franchise general managers' seminar program. This program provided continued training for the 75 general managers (through 1977) who elected to participate. The management training center mentioned above offers continued updating and career development assistance for midlevel management. For new and lower-level employees, the training department provides career planning assistance (and guidelines), as well as continuous updating on future opportunities within Days Inns and suggestions for incremental career goals.

53 With regard to employee benefits, the 1977 annual report offered the following comment:

> Employee benefits historically have been a major Days Inns priority, and 1977 was our most active year in implementing personnel programs. New direct-benefit packages include: longer vacations; additional holidays, including the employee's birthday; expanded life and health insurance; and a reimbursement policy to encourage continuing education.
>
> We introduced a series of programs designed to promote creative interaction between employees and management. Among these was a system to reward cost-saving suggestions by Days Inns personnel. We initiated a series of seminars with instruction tailored to job-related needs. To improve communication between the field and the home office, we held retreats and conferences for management at various levels and discussed common goals and problems.
>
> With the help of local merchants we arranged discounts which entitle Days Inns employees to substantial savings on a variety of products. These discounts are administered by our newly-created employee services branch.

54 Additional benefits include discounts (20 percent) on lodging and food at Days Inns properties throughout the system.

Growth strategy

55 Kessler described the growth experienced by Days Inns as a thoroughly calculated, preconceived process. "Our procedure," he said, "has been to climb and plateau, climb and plateau."

56 Indeed, a brief look at the company since its inception seems to verify this philosophy. The growth years were 1970 to 1973. Then there was a period of leveling from the fall of 1973 to mid-1975, when the company consolidated its financial and operational position.

57 Beginning in October 1976, Days Inns began to focus on internal growth and profitability. Employing some additional management talent for key positions was an important strategic move. Most of the effort was directed toward improving the profit picture at Days Inns. From 1976 to 1978 Days Inns enjoyed approximately a 50 percent increase in income before taxes each year. Days Inns pursued a balance in growth and profitability in 1979, devoting equal energies to each.

Future plans

58 At present, the most westward Days Inns units is located in Phoenix, Arizona. However, if Richard Kessler's dreams flourish, there just might be as many as 75 units in the states of California and Colorado by 1986.

59 While Kessler readily admits that development costs in California will run 15 to 20 percent above those in the Southeast, the potential in the Golden State market is literally staggering. Kessler explained, "The profit can be

realized by opening at Days Inns rates of $15.88 to $21.88. These rates offer an excellent value compared to the competition's rates of $25 to $45." A news release in late 1978 indicated that Days Inns opened a regional franchise sales and development office in Sacramento, California, and in Denver, Colorado.

60 An area for future expansion by Days Inns is fast-food service. Richard Kessler indicated that Days Inns opened three standardized, 33-seat, fast-service restaurants in late 1978. Called Day Break, these restaurants are open 24 hours each day and are located primarily in the commercial districts of metropolitan areas with Days Inns motels.

61 Kessler was careful to indicate that the future of Days Inns depends on being detail oriented, a factor he feels was "critical to our successful past." When asked to elaborate, Kessler said:

> Increased energy costs and higher minimum wage concerns are presently being addressed. Major emphasis will be placed on energy conservation and labor efficiency programs designed to reduce costs and to provide better service to our guests. Secondly, we are strengthening the franchise department which should increase franchise sales as well as better serve our franchise owners. The final goal is to continue to streamline systems and organizational lines. Programs to implement and achieve these three goals are now in progress, and the indicators are encouraging for another progressive year.
>
> Days Inns is now an industry leader in controlling costs. We have steadily reduced the average breakeven rate [occupancy] for a Days Inns property. While the industry average is around 65 percent, we expect to have a corporate 60 percent breakeven rate in fiscal 1978. Our goal is to remain detail oriented so as to bring this to a 50 percent breakeven level by 1980 and below 50 percent in the next decade.

62 The latest annual report for Days Inns echoed the sentiments of Richard Kessler in the following favorable comments on Days Inns's future:

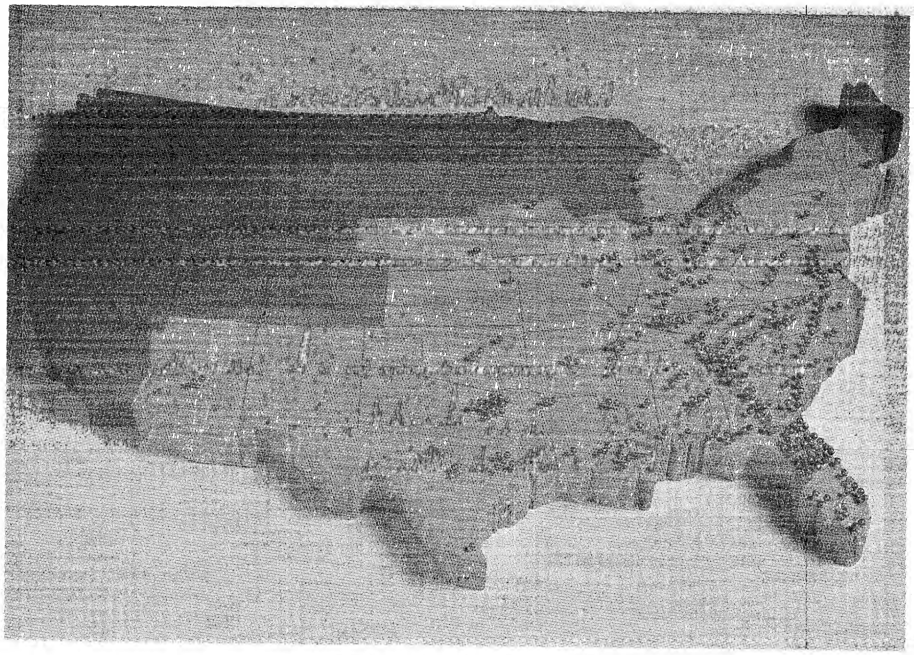
> General Comment on Projected Results of Operations 1979–1982
>
> Increases in company revenue are projected for all segments of the business. Increases in lodging revenue result from higher average room rates and higher occupancy. New programs and improved product lines, along with increased occupancy, contribute to expected higher food, gas, and novelty revenues. Franchise fees are projected to increase as a result of continued expansion as well as higher revenue related to occupancy and average room rates.

63 Reflecting the thoughts of Kessler and the Days Inns management team, Roy Burnette (senior vice president for marketing) summarized the future of Days Inns as follows:

> Days Inns management intends to continue its carefully defined and well-planned strategy of offering value, convenience, and comfort to the middle American as he travels. It will continue to key its services to the

exhibit 16

There are 289 Days Inns and Lodges in 193 cities



automobile traveler who utilizes interstates and major arteries. The desire is to create a family atmosphere with facilities equal to or better than its competitors. The company also will continue to appeal to the commercial traveler and senior citizen.

While others in the lodging industry alter their customer image, Days Inns feels strongly about maintaining the market niche that has given the company its success.

case 30

Days Inns of America, Inc. (B)

1 In 1980, Days Inns of America, Inc. (DIA), celebrated its 10th anniversary as a member of the lodging industry. While saddened by the death of its founder, Cecil Day, DIA's 10th birthday was an enviable celebration of record performance. DIA set company records in revenue, income before taxes, and net income of $118 million, $9.1 million, and $5.1 million, respectively. Through earnings and real estate appreciation, DIA's current value increased 44 percent ($26 million) in one year. Thus, DIA's financial position was at its strongest point in its 10-year history. Exhibit 1 provides financial highlights of DIA's performance over the last five years.

The Days Inn concept

2 At the heart of DIA's impressive 10-year growth has been its budget luxury concept as operationalized by Cecil Day. His concept, executed diligently by Richard Kessler, was to offer four basic traveler services—lodging, gasoline, restaurant, and gift shop—in a streamlined, no frills quality manner designed to appeal to the budget-conscious traveling family. By eliminating unnecessary luxuries (like large lobbies and lounges) and achieving operational efficiencies (like one cashier station for restaurant, gift shop, gas, and lodging receipts), DIA was able to offer standardized rooms similar to Holiday Inns, Ramada Inns, and Marriott at a 25 to 35 percent lower price. As they move into the 1980s DIA has eliminated the phrase budget luxury from

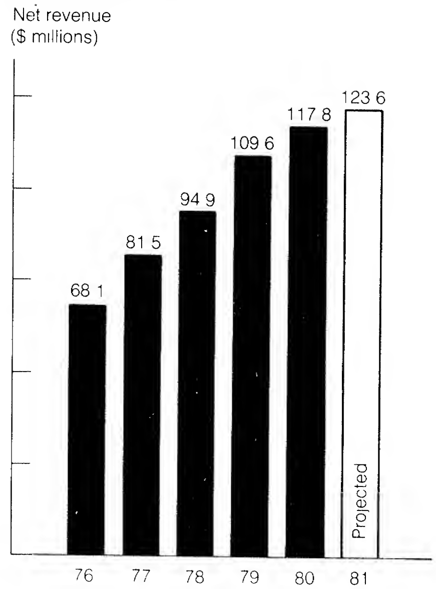
This case was prepared by Richard Robinson, University of South Carolina.

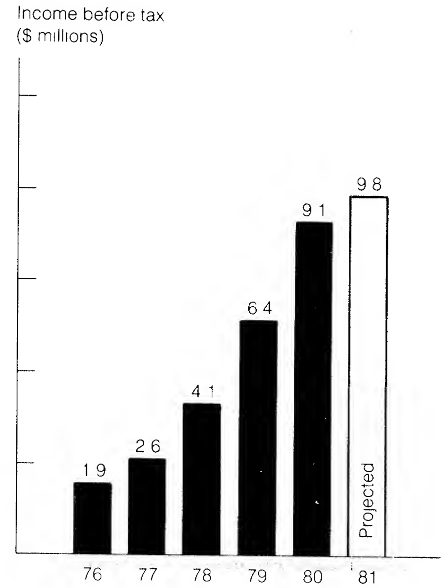
exhibit 1
Tenth anniversary financial highlights

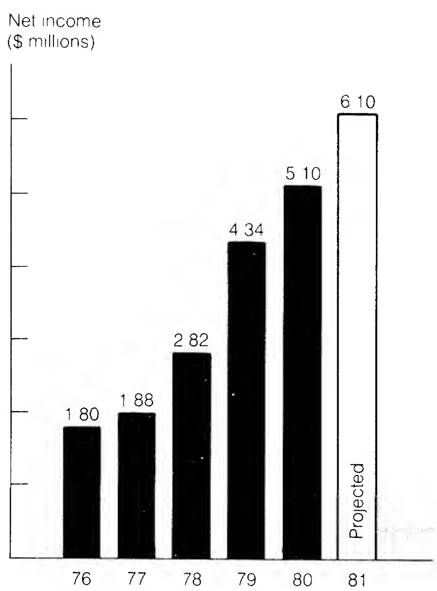
	September 30					
	*1981**	*1980*	*1979*	*1978*	*1977*	*1976*
Net revenue	$123,630,000	$117,782,000	$109,563,000	$94,883,000	$81,496,000	$68,133,000
Income before taxes	9,759,000	9,075,000	6,369,000	4,080,000	2,605,000	1,855,000
Net income	6,115,000	5,088,000	4,341,000	2,820,000	1,880,000	1,805,000
Working capital provided by operations	15,891,000	12,754,000	9,677,000	8,012,000	6,741,000	5,459,000
Stockholders' equity:						
Historical cost	18,887,000	13,073,000	8,240,000	4,657,000	2,464,000	611,000
Current value		86,200,000	60,666,000	44,429,000	28,107,000	22,041,000
Occupancy rate	71.0%	71.2%	74.1%	72.8%	70.7%	73.7%
Average room rate	$22.50	$20.25	$17.83	$16.02	$14.50	$12.54

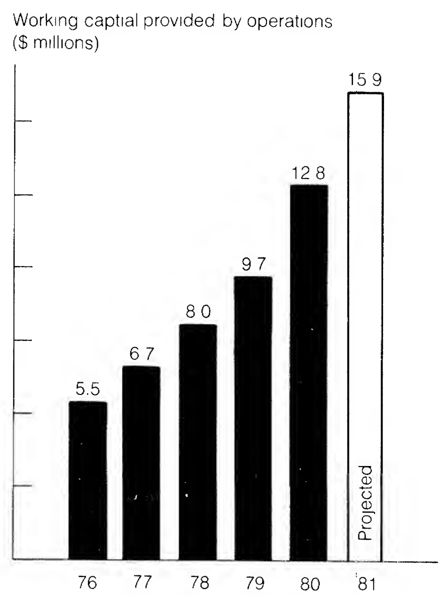
* Projected.

exhibit 1 ***(concluded)***









its vocabulary. But as the following excerpt from its 1980 annual report indicates, the underlying Days Inn concept remains unchanged:

> Days Inns of America, Inc., serves a significant but overlooked customer of the hotel-motel industry—the dollar-conscious middle American traveler.
>
> Our challenge is to offer competitive, quality lodging at the lowest possible price. We accomplish this goal by eliminating the unnecessary luxuries (like expansive lobbies and lounges) where the resulting cost savings will be appreciated by the guest. We also provide the convenience of one-stop service, offering food, novelties, gasoline, and lodging. This formula produced an unprecedented success story in the hotel-motel industry.

3 Asked to define exactly what the Days Inn concept is, Richard Kessler, the youngest chief executive officer (CEO) in the lodging industry, said:

> Our intent is to serve the value-conscious traveler. Our properties do not have elaborate lobbies, cocktail lounges, or convention facilities. A typical Days Inn property includes a family restaurant, a gift shop, and a self-service gasoline facility. Each inn has a swimming pool, full-size rooms with complete bath, two double beds, telephone, and color television. We offer our guests one-stop convenience for food, gasoline, relaxation, and a good night's lodging. As we have developed, our strategy has evolved but our basic concept is unchanged.

4 While DIA's concept remains unchanged, its market strategy has evolved considerably from what it was when Richard Kessler and Cecil Day built the first Days Inn in 1970 at Savannah Beach, Georgia.

Evolving market strategy at Days Inn

5 DIA's focused primarily on family travelers in its early development. Originally, DIA built along the interstate highways in the eastern United States to serve this market. Later, DIA focused on destination locations (particularly Florida) that received customers from the eastern interstate network. But as DIA moves into the 1980s, its market strategy has taken a new focus in order to accommodate changing trends in traveler characteristics.

6 Exhibit 2 provides DIA's projections of the changing customer mix for the travel industry in the 1980s. DIA does not interpret this to mean a movement out of its role of serving the budget-conscious family. Indeed, Richard Kessler considers this to be an important core constituency at Days Inns. Nonetheless, this changing customer mix has led DIA to link its future *growth* to the ability to cater to the growing segments as shown in Exhibit 2. Commenting on the typical Days Inn customer in the 1980s, Richard Kessler offered the following:

> Our guests are business men and women who pay their own expenses or travel on limited expense accounts. They are government employees and military personnel traveling on per diem. They are vacationing families who

exhibit 2
Changing customer mix in the lodging industry

The market by segments*		
	Now	Future
Family	65%	30%
Business	15%	40%
Over 55	15%	20%
Government/Military	5%	10%

* Days Inns of America, estimates of the changing mix.

want to minimize their lodging expense, younger adults raising families and purchasing homes, and senior citizens living on fixed incomes. The two latter groups, incidentally, will grow dramatically during the 1980s. The 35–44 age group will increase 51 percent in this decade and will take 44 percent more trips than the average of the general population. The 55 and older population will increase by 13.6 percent.

Kessler's assessment was reinforced by Tom Eppes, director of creative services:

> We are already experiencing a steady increase in business and government travelers. Most of these travelers, you must understand, are traveling on limited or fixed expense accounts. Many government employees, for example, are traveling on a $50/day per diem. Staying at a Holiday Inn will typically cost them around $40 to $45, leaving very little on which to eat. At Days Inns, they pay from $22 to $28 for comparable lodging, leaving them the ability to eat three meals a day.

7 To accommodate this changing customer mix, DIA has altered its marketing strategy in terms of site location and geographic location. For the 1980s, DIA will concentrate almost exclusively on major cities adjacent to centers of transportation, government, military, or commercial activity. In addition, DIA will seek airport locations, says Richard Kessler, because of the airlines' increasing role in serving a more transient America. Richard Kessler offered the following comments on DIA's move from an interstate emphasis to a major city emphasis:

> We have completed building the base of our north-south network in the East. Less than 50 percent of our business today (1981) comes from interstate properties. Our future depends on suburban locations in major centers of transportation, commerce, and government. Although we consider

downtown sites, we locate primarily in the suburbs because of the broader combined customer base of commercial and family travelers, because suburban properties generally have higher visibility and easier access, and because of high real estate appreciation.

8 Geographically, DIA will place major emphasis on westward expansion. In 1980, Days Inns opened its first Denver location with three more expected by 1982. The first California property was opened in 1981 in Sacramento. Kessler enthusiastically supports this westward expansion:

> The Denver-Rocky Mountains area is emerging as the energy center of the United States. In addition to its oil it has become the focal point in the search for and production of alternate energy sources, encompassing the prospectors and developers of oil shale, coal, uranium, and others. Denver is the location of the Solar Energy Research Institute as well, which will have a decided impact on the local economy. In addition, Denver is rebuilding into a major national business center. There is a tremendous influx of companies into the area. Colorado Springs has become a mecca for the electronics industry. Nine major electronics companies are there now and four more are building facilities. The Rocky Mountain area is bursting with growth, and the potential for long-term real estate appreciation is excellent.
>
> California offers everything that is called for in our strategic planning. It has a $16 billion tourist industry, an occupancy rate 9 percentage points higher than the national average, and a population of 20 million, which is nearly 10 percent of the U.S. population. Its economy of $315 billion is the ninth largest in the world, larger than that of Canada or Australia. It has 113 major military installations (more than any other state in the country), large government operations, great concentrations of higher education and high-technology industry. The population is very mobile. Twenty-five million people traveled through the state in 1979. We see very little competition in the California market that can match Days Inn motels in quality and price.

9 While DIA will look westward, key markets are still being developed east of the Mississippi. In what promises to be DIA's biggest growth year since the mid-1970s, DIA plans to add 18 new properties in fiscal 1981. Shown in Exhibit 3, 12 of these new locations are still in the East.

10 Kessler has repeatedly said that he follows a "grow and plateau" formula in expanding the Days Inn network. From 1978 through 1980, DIA was at a plateau phase, adding a net increase of only nine locations, but 1981 appears to signal the reemergence of a growth cycle at DIA. Tom Epps indicates

exhibit 3
New locations for fiscal 1981

Atlantic City	Denver (2)	Richmond, Virginia
Atlanta airport	Los Angeles	Sacramento
Austin, Texas	Miami	San Francisco
Baltimore	New Orleans	Savannah, Georgia
Birmington, Alabama	Norfolk, Virginia	Washington, D.C.
Columbia, Georgia	Reno	

"DIA plans to add 12 or more properties for the next several years," suggesting Kessler is looking for a much higher plateau.

11 Talking with *Lodging* magazine, Kessler summarized this new growth phase at Days Inns in simple terms: "We plan to go downtown. And to Washington, D.C. And out West—particularly to Texas, Colorado, and California."

Financial position

12 Exhibit 1 provides a basic summary of DIA income since 1975. Exhibit 4 provides a breakdown of income for 1980 and 1979. By the end of 1980, the DIA system had 44,135 rooms (59 percent franchised, 41 percent company owned and/or operated) with an average revenue per rented room of $38.73 from all revenue sources on the property. This figure was up from $34.15 in 1979. Control of operating costs has allowed DIA to achieve a breakeven occupancy rate of 50 percent, well below the industry average of 65 percent.

exhibit 4

DAYS INNS OF AMERICA, INC.
Consolidated Statements of Income
For the Years Ended September 30, 1979 and 1980

	1980	*1979*
Net revenue:		
Lodging	$ 52,241,000	$ 48,065,000
Food, gasoline, and novelties	47,067,000	44,024,000
Franchise fees—initial	620,000	566,000
Recurring	11,176,000	9,795,000
Rental income	4,139,000	3,921,000
Other income	2,539,000	2,192,000
Proceeds from officer's life insurance (Cecil Day)		1,000,000
Total revenues	117,782,000	109,563,000
Costs and expenses:		
Cost of food, gasoline, and novelties	33,766,000	31,434,000
Selling, general, administrative, and operating expenses	56,590,000	52,860,000
Rental expense—motel and restaurant leases	9,068,000	10,411,000
Depreciation and amortization	5,776,000	5,222,000
Interest expense, net of interest income of $1,139,000 and $655,000	3,507,000	3,267,000
Total expenses	108,707,000	103,194,000
Income before provision for income taxes	9,075,000	6,369,000
Provision for income taxes	3,987,000	2,028,000
Net income	$ 5,088,000	$ 4,341,000

13 The company set revenue and net income records for DIA in 1980, as mentioned earlier. Working capital provided by operations was $12,754,000, also a record (see Exhibit 5). Stockholders' equity was $13,073,000 on an historical cost basis and $86 million based on current value (see Exhibit 6). During 1980 DIA added $26 million to the company's value, only 20 percent

exhibit 5

DAYS INNS OF AMERICA, INC.
Consolidated Statements of Changes in Financial Position
For the Years Ended September 30, 1979 and 1980

	1980	*1979*
Financial resources were provided by:		
Operations:		
Net income	$ 5,088,000	$ 4,341,000
Add income charges (credits) not affecting working capital:		
Depreciation and amortization	5,776,000	5,222,000
Deferred income taxes	2,023,000	42,000
Amortization of deferred charges	69,000	72,000
Equity in undistributed earnings of affiliated companies	(202,000)	
Working capital provided by operations	12,754,000	9,677,000
Increases in notes payble		4,076,000
Capital lease obligations	$32,974,000	3,735,000
Disposal of property and equipment	3,399,000	2,270,000
Increase in deferred income and deposits	42,000	
Decrease in receivables from stockholders and affiliated companies		152,000
Sale of treasury stock	9,000	
Equity in undistributed earnings of affiliated companies	202,000	
Other		19,000
Total working capital provided	49,380,000	19,929,000
Financial resources were used for:		
Capital leases	32,974,000	3,735,000
Acquisition of property and equipment	6,496,000	9,971,000
Reductions of notes payable	5,717,000	4,606,000
Increase in receivables from stockholders and affiliated companies	1,265,000	
Increase in receivables from nonaffiliated franchisees and others	894,000	158,000
Increase in other assets	650,000	
Cash dividends	251,000	
Decrease in deferred income and deposits		248,000
Increase in deferred charges	145,000	
Purchase of treasury stock	13,000	758,000
Total working capital used	48,405,000	19,476,000
Increase in working capital	$ 975,000	$ 453,000
Analysis of changes in working capital:		
Increase (decrease) in current assets:		
Cash	$ 418,000	$ 44,000
Money market investments	1,533,000	1,027,000
Accounts and notes receivable:		
Affiliated companies	(157,000)	293,000
Nonaffiliated franchisees	(316,000)	(544,000)
Other	(527,000)	946,000
Retail inventories and supplies	10,000	358,000
Prepaid expenses	352,000	32,000
(Increase) decrease in current liabilities:		
Notes payable	(1,065,000)	1,073,000
Accounts payable	1,965,000	(2,371,000)
Accrued expenses and other liabilities	(761,000)	(81,000)
Income taxes payable	(728,000)	326,000
Deferred income taxes	251,000	(650,000)
Increase in working capital	$ 975,000	$ 453,000

exhibit 6

DAYS INNS OF AMERICA, INC.
Consolidated Balance Sheets (Historical Cost)
and Statements of Current Values
For the Years ended 1979 and 1980

	September 30, 1980		September 30, 1979	
	Statement of current values	*Balance sheet (historical cost)*	*Statement of current values*	*Balance sheet (historical cost)*
Assets				
Current assets:				
Cash ($60,000 restricted)	$ 554,000	$ 554,000	$ 136,000	$ 136,000
Money market investments	5,563,000	5,563,000	4,030,000	4,030,000
Accounts and notes receivable, net of allowance for doubtful accounts of $810,000 and $950,000				
Affiliated companies	322,000	322,000	479,000	479,000
Nonaffiliated franchisees	1,095,000	1,095,000	1,411,000	1,411,000
Other	1,234,000	1,234,000	1,761,000	1,761,000
Retail inventories and supplies	1,852,000	1,852,000	1,842,000	1,842,000
Prepaid expenses	1,022,000	1,022,000	670,000	670,000
Total current assets	11,642,000	11,642,000	10,329,000	10,329,000
Property and equipment	132,536,000	98,776,000	101,539,000	65,267,000
Less: Accumulated depreciation		(24,337,000)		(21,205,000)
Accounts and notes receivable:				
Stockholders and affiliated companies	5,934,000	5,934,000	4,669,000	4,669,000
Nonaffiliated franchisees and other, net of allowance for doubtful accounts of $390,000 and $450,000	947,000	947,000	53,000	53,000
Franchise agreements	21,000,000		18,500,000	
Deferred charges	642,000	642,000	648,000	648,000
Accumulated income tax prepayments			85,000	85,000
Parent company stock	18,734,000	202,000		
Other assets	487,000	487,000	39,000	39,000
Total assets	$191,922,000	$ 94,293,000	$135,862,000	$ 59,885,000

exhibit 6 ***(concluded)***

Liabilities and Stockholders' Equity

Current liabilities:				
Notes payable	$ 3,560,000	$ 3,831,000	$ 2,491,000	$ 2,766,000
Accounts payable	3,484,000	3,484,000	5,449,000	5,449,000
Accrued expenses and other liabilities	3,643,000	3,643,000	2,882,000	2,882,000
Income taxes payable	1,124,000	1,124,000	396,000	396,000
Current liabilities excluding deferred income taxes	11,811,000	12,082,000	11,218,000	11,493,000
Deferred income taxes	399,000	399,000	650,000	650,000
Total current liabilities	12,210,000	12,481,000	11,868,000	12,143,000
Notes payable, due after 1 year	59,579,000	63,563,000	32,536,000	35,564,000
Accounts and notes payable to stockholders and affiliated companies, due after 1 year	2,200,000	2,576,000	3,072,000	3,318,000
Income taxes on realization of estimated current values	24,528,000		23,500,000	
Real estate commissions on realization of estimated current values	4,605,000		3,600,000	
Deferred income taxes	1,938,000	1,938,000		
Deferred income and deposits	662,000	662,000	620,000	620,000
Stockholders' equity:				
Common stock, without par value—1 million shares authorized, 341,670 shares issued	59,000	59,000	59,000	59,000
Capital surplus	949,000	949,000	949,000	949,000
Retained earnings	13,768,000	13,768,000	8,931,000	8,931,000
Unrealized appreciation	73,127,000		52,426,000	
	87,903,000	14,776,000	62,365,000	9,939,000
Less: Treasury stock, at cost—33,475 and 33,460 shares	1,703,000	1,703,000	1,699,000	1,699,000
Total stockholders' equity	86,200,000	13,073,000	60,666,000	8,240,000
Commitments and contingent liabilities				
Total liabilities and stockholders' equity	$191,922,000	$ 94,293,000	$135,862,000	$ 59,885,000

of which was in historical accounting net income. The balance, 80 percent, was in real estate and other asset appreciation.[1] DIA's debt-to-equity ratio has been reduced to 6:2. For those short periods during the year when its flow of funds fluctuates, DIA has available $6 million of unsecured lines of bank credit to draw upon.

14 During 1980 DIA spent $13.9 million on capital replacement items, refurbishing company properties. Over the past three years that figure is $38.8 million, most of it coming out of cash flow and none of it from the proceeds of short-term debt. DIA spent more than $1 million this year on a new nationwide toll-free reservation system. According to Kessler, DIA "can support those kinds of expenditures without resorting to short-term debt because of the cash our business generates."

15 To monitor its cash needs, DIA places major emphasis on financial forecasting. Exhibit 8 illustrates corporate-level forecasts for the next five years and forecasting accuracy for fiscal 1980. DIA carries such forecasting to the individual motel on a weekly basis.

16 Financing DIA's ambitious growth plans for the 1980s will be a challenge for DIA. Real estate and construction costs are rapidly escalating in the major city centers DIA has targeted. When asked about this, Kessler and Ken Niemann (chief financial officer) said:

Kessler: Right now, for example, we are financing some properties with industrial revenue bonds, through both private placements and public offerings, and we are pursuing additional IRB funding. We have just signed agreements with a consortium of banks for $30 million in revolving lines of credit. Ken Niemann, our chief financial officer, can give you details on that.

[1] DIA places major emphasis on the appreciation of its growing real estate investment (motel properties) as an important indicator of true corporate performance. Exhibit 7 illustrates this emphasis providing DIA's annual consolidation of current values statement that is included in its annual reports.

exhibit 7

DAYS INNS OF AMERICA, INC.
Consolidated Statement of Current Values
For the Years Ended September 30, 1979 and 1981

The consolidated statements of current values are supplementary information which provide relevant information about the assets and liabilities of the company which is not provided by traditional financial statements (historical cost basis). Although current values differ significantly from the historical cost amounts and are not required for presentation of financial position in conformity with generally accepted accounting principles, management believes that such information is useful to the readers of its financial statements.

Current value accounting is presently in an experimental stage and authoritative criteria have not been established for the preparation and presentation of current value information. Accordingly, as experimentation proceeds, the principles followed in the statements of current values may be modified. Furthermore, unanticipated events and circumstances may occur after September 30, 1980 which cause actual current values to vary substantially from the values estimated herein.

Management's estimates of current values were reviewed and analyzed by Landauer Associates, Inc., real estate consultants, whose letter of concurrence accompanies this note.

The consolidated statements of current val-

exhibit 7 ***(concluded)***

ues do not represent the amount that could be realized from the sale of the company; rather, the values estimated to be realizable in an orderly disposition of the company's individual assets and liabilities under the willing buyer/willing seller concept. The values of the interest in the company's various properties is the estimated current investment which investors would make to purchase the company's interest in each property's future cash flow.

Management's estimates of unrealized appreciation of $73,127,000 and $52,426,000 at September 30, 1980 and 1979, respectively, are summarized as follows:

	1980		*1979*	
	Current values	*Historical cost basis*	*Current values*	*Historical cost basis*
Property and equipment interests:				
Motels owned and leased to others	$ 23,400,000	$12,132,000	$26,200,000	$14,543,000
Motels and other facilities leased from others (including capital leases)	89,960,000	46,360,000	56,468,000	13,796,000
Office building, warehouse, and travel trailer park	7,215,000	6,147,000	6,120,000	5,708,000
Motels owned and operated	10,216,000	8,055,000	11,805,000	9,078,000
Construction-in-progress	804,000	804,000		
Unimproved land	941,000	941,000	946,000	946,000
	132,536,000	74,439,000	101,539,000	44,062,000
Franchise agreements	21,000,000		18,500,000	
Equity in underlying net assets of parent company stock	18,734,000	202,000		
	172,270,000		120,039,000	
Historical cost basis	(74,641,000)	$74,641,000	(44,062,000)	$44,062,000
Current value reduction in notes payable	4,631,000		3,549,000	
Real estate commissions on realization of estimated current values	(4,605,000)		(3,600,000)	
	97,655,000		75,926,000	
Income taxes on realization of estimated current values	(24,528,000)		(23,500,000)	
Unrealized appreciation	$ 73,127,000		$ 52,426,000	

	1980	1979
A reconciliation of unrealized appreciation for the years ended September 30, 1980 and 1979 is as follows:		
Unrealized appreciation at beginning of year	$ 52,426,000	$ 39,772,000
Increase (decrease) during the year:		
Leasehold interests	928,000	12,885,000
Leased fee interests	(398,000)	626,000
Revaluation of notes payable	1,082,000	1,724,000
Franchise agreements	2,500,000	3,000,000
Motels owned and operated	(566,000)	622,000
Other	656,000	97,000
Additional costs of disposition	(2,033,000)	(6,300,000)
Equity in underlying net assets of parent company stock	18,532,000	
Unrealized appreciation at end of year	$ 73,127,000	$ 52,426,000

exhibit 8

DAYS INNS OF AMERICA, INC.
Comparison of Actual to Forecasted Income and Stockholders' Equity
For the Years Ended September 30, 1980

	Actual	*Forecasted*	*Variance*
Net revenue:			
Lodging	$ 52,241,000	$ 50,756,000	$ 1,485,000
Food, gasoline, and novelties	47,067,000	50,132,000	(3,065,000)
Franchise fees—initial	620,000	538,000	82,000
Recurring	11,176,000	10,907,000	269,000
Rental income	4,139,000	4,187,000	(48,000)
Equity in undistributed earnings of affiliates	202,000		202,000
Other income	2,337,000	2,378,000	(41,000)
Total net revenue	117,782,000	118,898,000	(1,116,000)
Costs and expenses:			
Cost of food, gasoline, and novelties	33,766,000	36,875,000	(3,109,000)
Selling, general, administrative, and operating expenses	56,590,000	55,284,000	1,306,000
Rental expense	9,068,000	9,584,000	(516,000)
Depreciation and amortization	5,776,000	6,097,000	(321,000)
Interest expense net of interest income	3,507,000	3,332,000	175,000
Total costs and expenses	108,707,000	111,172,000	(2,465,000)
Income before provision for income taxes	9,075,000	7,726,000	1,349,000
Provision for income taxes	(3,987,000)	(3,327,000)	(660,000)
Net income	$ 5,088,000	$ 4,399,000	$ 689,000
Stockholders' equity	$ 13,073,000	$ 12,388,000	$ 685,000
Occupancy	71.2%	73.0%	(1.8%)
Average room rate	$20.25	$19.00	$1.25
Number of franchise motel openings	10	20	(10)
Total rooms in chain	44,315	45,000	(685)

exhibit 8 *(concluded)*

Statements of Forecasted Income and Stockholders' Equity
For the Years Ending September 30, 1981–1985

	1981	*1982*	*1983*	*1984*	*1985*
Net revenue:					
Lodging	$ 56,644,000	$ 62,218,000	$ 68,139,000	$ 74,396,000	$ 80,995,000
Food, gasoline, and novelties	47,366,000	53,161,000	59,477,000	66,231,000	73,500,000
Franchise fees—initial	317,000	419,000	532,000	635,000	738,000
Recurring	11,964,000	14,023,000	15,706,000	17,768,000	20,232,000
Rental income	3,250,000	1,124,000	1,207,000	1,297,000	1,399,000
Equity in undistributed earnings of affiliates	1,045,000	1,851,000	2,564,000	3,226,000	4,519,000
Other income	3,044,000	3,473,000	3,503,000	3,724,000	3,946,000
Total net revenue	123,630,000	136,269,000	151,128,000	167,277,000	185,329,000
Costs and expenses:					
Cost of food, gasoline, and novelties	33,165,000	37,435,000	42,023,000	46,934,000	52,187,000
Selling, general, administrative, and operating expenses	58,950,000	64,889,000	71,645,000	78,937,000	86,914,000
Rental expense	5,975,000				
Depreciation and amortization	8,731,000	10,104,000	10,823,000	11,135,000	11,714,000
Interest expense net of interest income	7,050,000	10,593,000	10,833,000	11,502,000	11,987,000
Total costs and expenses	113,871,000	123,021,000	135.324,000	148,508,000	162,802,000
Income before provision for income taxes	9,759,000	13,248,000	15,804,000	18,769,000	22,527,000
Provision for income taxes	(3,644,000)	(5,159,000)	(6,012,000)	(7,093,000)	(8,249,000)
Net income	$ 6,115,000	$ 8,089,000	$ 9,792,000	$ 11,676,000	$ 14,278,000
Stockholders' equity	$ 18,887,000	$ 24,628,000	$ 34,420,000	$ 46,096,000	$ 60,374,000
Occupancy	71.0%	72.0%	73.0%	74.0%	75.0%
Average room rate	$22.50	$23.50	$24.50	$25.50	$26.50
Number of franchise motel openings	6	23	27	31	35
Total rooms in chain	45,200	48,300	52,400	57,100	62,200

Niemann: We have a commitment for $30 million in interim financing. That means we do not have permanent financing arranged for a property before we build it. The banks will carry the loan until we find a permanent lender, for a period of 8–12 years. When we get the permanent financing and pay off the bank loan, that amount is added back to our line of credit. This gives us great flexibility, allowing us to purchase a site and begin development without the risk of losing a prime location while we are searching for permanent financing. It also lets us enter the permanent loan market at the most advantageous time. But we will continue to seek long-term commitments from traditional sources such as savings and loan associations, pension funds, and life insurance companies. We are currently in discussions with several sources that have the ability to finance a number of projects under a single commitment.

17 While a privately held corporation, DIA follows the unusual practice of providing annual reports similar to publicly held firms. This practice has intermittently fueled specuation that DIA is laying the groundwork for going public. With its ambitious growth plans, this would be a logical financing alternative. When asked if he was considering taking Days Inns public, Kessler said:

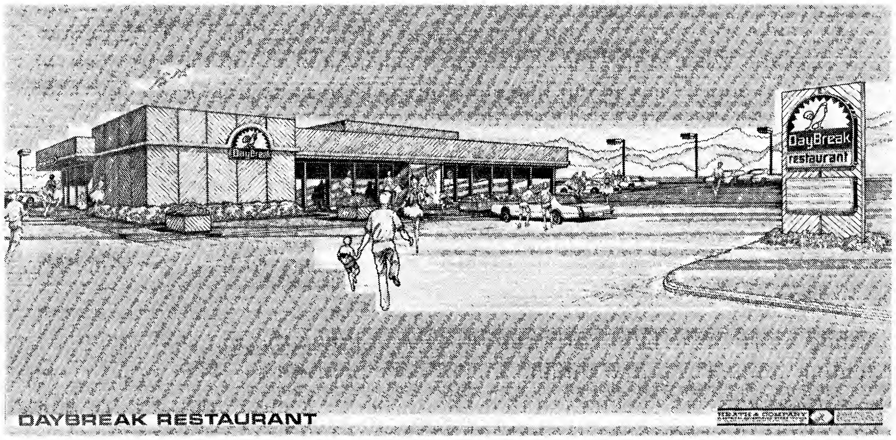
> No, our ownership will remain with Cecil B. Day Companies, and with those key executives whose motivation and dedication make the company successful. We see distinct advantages to being a private company, and we intend to remain one. Being private lets long-run decisions override short-term considerations. It relieves us of the pressure to show increased earnings each period. Such pressure often motivates the sale of valuable, appreciating assets in order to improve earnings. We think we are better able than a public company to create a good long-term strategic plan and to implement it in a cyclical marketplace.

18 In addition to upholding Cecil Day's desire to remain privately held, Kessler has continued a financial tradition he and Day started in 1970. DIA continues to tithe 10 percent of its profit after taxes to benefit religious and social projects.

DayBreak Restaurants

19 In 1978, DIA announced a new venture into the 24-hour, fast-service restaurant market (see Exhibit 9) called "DayBreak." These freestanding 35-seat units were designed to be operated by as little as one person and targeted for office, shopping, and industrial complexes with heavy lunch businesses. There are now 17 DayBreak restaurants in operation or under construction which, according to Bob Burnette (chief operations officer), have been well received. While originally conceived as a freestanding chain, most DayBreak restaurants are being built adjacent to Days Inns in metropolitan locations. They serve the same role as the previous Tasty World restaurants in terms of a multipurpose cashier function. According to Tom Epps, future plans for DayBreak restaurants do not include freestanding locations.

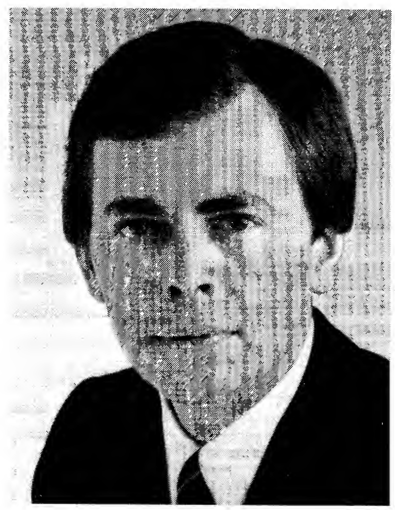
exhibit 9



Rather, DayBreak restaurants will accompany motels that are built in commercial markets," said Epps, "and Tasty World restaurants will be built only at family-oriented properties."

Leadership at Days Inns

20 With the loss of Cecil Day, Days Inns' founder, in 1979, it would not have been surprising to see the tightly held motel enterprise flounder as it readjusted to a leadership transition. Such occurrences are quite common in small- and medium-sized firms where the founder is a central driving force. At DIA, no such floundering occurred. Richard Kessler, who was appointed chief executive officer by Day in 1977 at the youthful age of 29, was well entrenched in the leadership of the DIA enterprise. As shown in the November 1979 interview with *The Atlanta Journal* (see Exhibit 10), Richard Kessler has been a key decision maker at Days Inns since it opened the first motel.



Richard Kessler Chief Executive Officer and Chairman of the Board

21 Top management at DIA has remained virtually unchanged since the mid-1970s. The one exception was the departure in 1980 of Doug McClain,

exhibit 10

The Rise of Richard Kessler

Leaning forward on the couch of his expensively furnished office in the Day Building on Buford Highway, 33-year-old Richard C. Kessler says he can't think of any failures he's had while working for Days Inns of America.

"I don't think I've blown it anywhere along the way in the past eight years," he says.

As president and chairman of the board of the country's sixth largest lodging chain, Kessler's self-confidence isn't surprising. He started working for Cecil B. Day Sr. when Day founded Days Inns in 1970, and has never looked back.

Now running a 307-motel chain whose reservation system gets 4 million calls a year (fourth largest in the country) at what he says is the lowest cost per call in the industry, Kessler talked about his start with the company.

Before he graduated from Georgia Tech in 1970 with a master's degree in industrial engineering, Kessler interviewed with several real estate and development companies in Atlanta, but all would have put him in a very narrow, specialized job.

"I wanted to work quickly with a top person in the real estate business," Kessler says. He had talked with Day before entering Tech, and talked to him again about finding a job.

In May 1970, Day met with Kessler at Savannah Beach, where they later built the first Days Inn. Kessler signed on as Day's personal assistant, and soon Kessler's father, a contractor, was knocking down the old Tybee Hotel to clear a site for the 60-room motel.

For most of the next two years, Kessler supervised the company's building program. While on a trip to Orlando, Fla., before Disney World opened, Kessler says he "felt the potential" for real estate growth in the area. When he returned to Atlanta, he told Day he should open a development office in Orlando.

Fine, Day answered, "How would you like to go down there and run it?" he asked Kessler. Kessler agreed, and spent the next three years in Florida. Those years included the gas shortages, recession, and depressed real estate market of 1973–74.

"Cecil called me one day in the summer of 1973 and said, "Something's happening in this market. Let's reel in our horns and get prepared to weather an economic storm.' Three weeks later the oil embargo was announced," Kessler says.

Banks then cut off all funds to the motel business, Kessler says, "We had to make it with whatever cash we had in the system. I told my people, 'It is survival time.' We are going to find out how strong we are.'"

Before the gas shortage, Kessler and Day had set up Day Realty of Orlando and Day Realty of Florida to build motels that Days Inns of America would lease and operate. To adjust for the recession, Kessler relieved the parent company of its leasing obligations and took over a 2,000-room operation.

"I wanted to put my fate in my own hands, by actually running the motels," Kessler says. He owned 30 percent of the Florida company, and his financial prospects were tied heavily to the Florida operation.

Kessler, Day, and Days Inns all survived the recession. By 1975, however, Day was convinced that he needed management help in Days Inns of America and called Kessler back to Atlanta to help out.

"Cecil called me and said he had a problem in Atlanta, and that he needed help with it," Kessler says. Kessler insisted that he report directly to Day. Day doubled Kessler's salary, made him chief financial officer, in charge of everything except the chain's field operations, and promised him the company's presidency in 18 to 24 months if he did a good job.

"I knew that I could do it," Kessler

exhibit 10 ***(concluded)***

says, "I always had it in mind that I would come back to Days Inns and run it."

With a new controller, Kessler says he rebuilt the company's financial systems in a year, and placed $8 million worth of permanent loans with banks to replace motel construction loans. Today Kessler is responsible for 307 Days Inns and Days Lodges (which offer one-bedroom apartment-like suites instead of simple rooms) of which 110 are owned and operated by the parent company. The rest are franchised.

The privately held company is turning record profits, and Kessler says one of his most satisfying successes is "seeing the teamwork at Days Inns come together in the last year." October is a traditional "down" month in the motel business, he says, but this October the company showed pretax income of $546,000 despite a drop in occupancy rates. Last October 1978 was the first October that the company showed a profit, and it was only $111,000, so Kessler is convinced that better days are ahead for Days Inns.

Although he believes gas prices will continue to rise to the world price of about $2 per gallon and that inflation will hover around 10 percent annually, Kessler says 1980 should be good for Days Inns. "Americans are going to travel," he says. "They may delay a trip, but they won't cancel it."

Kessler's conversation about his 9½ years with Days Inns includes many stories that begin, "Cecil called me up and said. . . ." Kessler explains: "I carried out his ideas. My job was to implement them."

Day died of bone cancer in December 1978 at age 44, so Kessler has been on his own.

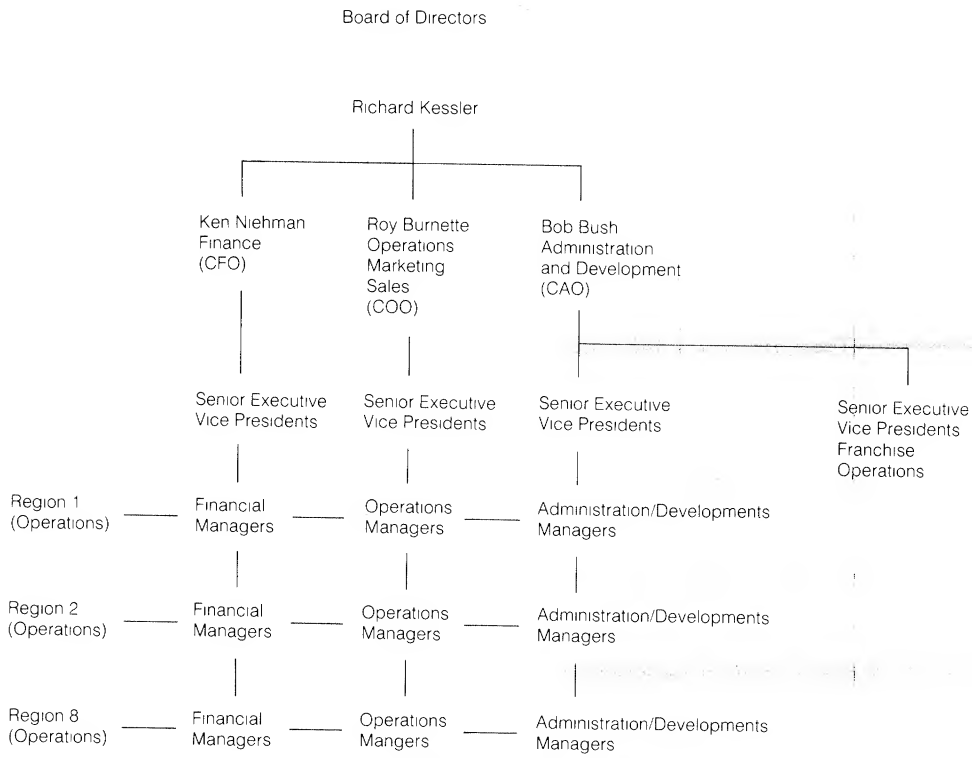
Kessler owns 10 percent of the stock in Days Inns of America. About 81 percent is owned by a holding company Day formed in 1978, called the Cecil Day Co. Kessler also owns between 23 percent and 30 percent of eight realty companies associated with Days Inns.

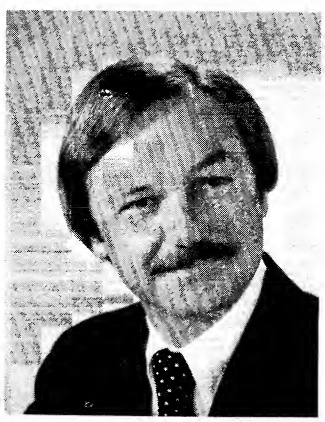
Source: David B. Hilder, "The Rise of Richard Kessler," The Atlanta Journal, November 30, 1979.

vice president for operations. McClain left DIA to join a motel development group.

22 This departure led Kessler to reexamine the appropriateness of the management and organizational structure at DIA for the 1980s. This reexamination culminated in reorganizing DIA along what Kessler termed the "forum concept." Under this concept, DIA was organized in a matrix-type format with multiple management forums providing flexible yet tight management control of DIA's rapidly growing and dispersed locations. Exhibit 11 provides a brief sketch of Kessler's forum organization. In this concept, the top management forum is composed of Kessler, Neihman, Burnette, and Bush. Additional forums are developed vertically along functionally specialized lines and horizontally along regional operating lines. This concept thus seeks to maintain tight control and expertise in DIA's strategic functional activities while maintaining integrated accountability and flexibility at regional operating levels.

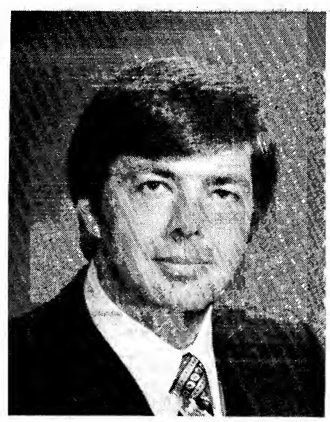
exhibit 11
The forum concept at Days Inn





Ken Niemann

Chief
Financial Officer



Roy Burnette

Chief
Operating Officer

Bob Bush

Chief
Administrative Officer

Days Inns in the 1980s

23 DIA's corporate objectives (see Exhibit 12) remain unchanged as the guiding force behind its mission for the 1980s.

exhibit 12
Days Inns' mission and corporate objectives

Days Inns of America, Inc., is a privately held corporation committed to fulfilling its business responsibilities within the framework of Christian ethics. In doing so, the company intends to exert the kind of positive influence which strengthens the free enterprise system. In accomplishing this commitment, the company actively pursues the following primary objectives:

1. To maintain the health of the corporation and to ensure its continued existence and growth through superior performance.
2. To benefit society by improving the quality of life of both employees and customers, by promoting healthy family life, and by encouraging small business enterprise through franchising.
3. To earn fair and satisfactory profits by offering excellent hospitality services at a real value to the customer.
4. To develop and maintain an environment in which all employees can realize their highest business potential, achieve personal fulfillment, and find genuine enjoyment through positive accomplishments.
5. To create a business environment in which dedicated teamwork makes possible the economic prosperity and security of both company and employees.

24 For Richard Kessler, the 34-year-old president of Days Inns, the 10th anniversary is a launching pad for the future. "We know where we are and where we are going," Kessler says. "We have the three basic components to make it in the 1980s. First of all, because Days Inns is a privately held company," says Kessler, "we have the flexibility to make decisions not necessarily based on immediate profits."[2]

25 The second ingredient in the Days Inns formula is its character as an entrepreneurial company, which Kessler believes adds a dimension of interaction and excitement to the business.[3]

26 This excitement helps the company attract top-notch, creative people, Kessler's third component for success. Many of his executives have been with the company since the early 1970s and have since risen to top-management positions, with ownership interests in the company. A spirit of optimism and creativity surrounds the staff at the Days Inns headquarters in Atlanta. "People-wise, we're in the best shape we've ever been in," says Kessler. "We've been growing talent in a tree-farm environment. The people know how we operate."[4]

27 "Knowing how we operate" translates into an unswerving belief in the founding Days Inns concept. When asked about major lodging chain move-

[2] "Days Inns Rises to the Challenge of the 1980s," *Lodging Hospitality*, July 1980, p. 42.
[3] Ibid.
[4] Ibid.

ment into casino gaming, several executives responded that Days Inns "would never get into gambling or even add lounges to its motel facilities." One executive, Tom Eppes, elaborated on this stance:

> We're profiting from that (movement by Holiday Inns, Ramada Inns, Hilton, etc.). As they move toward such "high end entertainment," it leaves a good bit of their previous market behind. As they increase their gambling and entertainment-related emphasis, we increase our market share by providing the budget-conscious consumer with accommodations Holiday Inns and others can no longer afford to provide.

28 These executives perceive competitors' movements into high-end amenities as leaving behind families and business travelers who used to stay with Holiday Inns and similar firms. From Days Inns' perspective and market research, "these travelers don't want to cut travel but do want to economize while traveling." Eppes points to Holiday Inns new Holidomes, a series of metropolitan properties with domed courtyards to provide recreational opportunities for exercise-conscious travelers, as an example of leaving the cost-conscious traveler behind. "Considering the energy costs and people cost in operating such a facility," he says, "there is no way they can profitably serve anyone but the high-end traveler."

29 With this type of movement by bigger competitors, Days Inns' executives see a vast U.S. market for the Days Inns concept. "California, the biggest traveled state in the United States," says Epps, "offers dozens of market opportunities for Days Inns locations." When asked about future plans for international expansion, Eppes summarized Days Inns focus for the 1980s:

> Eventually, we may develop internationally. We currently have our location in Ontario, Canada. But there are so many U.S. markets for the Days Inns concept, we will keep ourselves busy just keeping up with those for at least the next decade.

case 31

Best Western International, Inc. (A) and (B)

1 "If we ever committed ourselves to a single purpose, we would revolutionize the entire lodging industry." Commitment is certainly not lacking among the tier of top managers at Best Western International, Inc. Chief executive officer, Bob Hazard, embodies his statement. In a five-year period, Hazard has directed the metamorphosis of a once sleepy Phoenix, Arizona, based lodging referral network to a full-service chain. Today Best Western is the largest lodging chain in the world with more than 2,500 individually owned and operated inns, hotels, and resorts throughout the United States and in 18 foreign countries.

2 The strength of the Best Western operation has always centered on the independent unit owner. Best Western was founded in 1948 by M. K. Guertin, a California entrepreneur who was forever seeking novel ways to increase business at his motel. Guertin was convinced that many of his customers would appreciate referral suggestions for quality motels throughout California. Based on the potential of this premonition, Guertin set out to examine properties in the area that maintained high standards of comfort and cleanliness at a reasonable price. From these humble beginnings, the loosely knit referral organization grew to nearly 500 properties by 1960.

3 In the early 60s, members of the network recognized that as their numbers grew, a more structured system of guidelines, a unified marketing effort, and improved quality control methods were required. Specific objectives and standards were established, and the group incorporated as Western Motels, Inc. This new direction proved quite successful. Notoriety of the network grew, and many property owners in the East sought membership in the organization. As the company grew, the members established guidelines for governance and elected a board of directors. In 1966, the highly successful referral organization decided to establish its headquarters in Phoenix, Arizona.

4 The bubble of success was nearly burst by infighting in the late 1960s and early 1970s that permeated the company. Rumors that the network would sell its name to Standard Oil of Indiana, accompanied with major disagreements on structure and direction, divided the membership.

5 In 1974, under the direction of Peter Wurst, a co-owner of seven Best

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This case was prepared by Professors Sheila A. Adams and Timothy S. Mescon of Arizona State University.

Western properties, the organization emerged from its troublesome days with a new corporate mission.

6 In November 1974, Best Western's board of directors decided to drop the referral organization image, drop the word *motel* from its name, and begin competing directly with other full-service chains in the industry.

7 To direct this new effort, the board hired Bob Hazard, vice president of hotels at American Express. Hazard, in turn, brought in Gerald Petitt, a colleague at American Express, to handle operations of the newly revamped organization.

8 "Our member services are so comprehensive that we believe they can't be matched anywhere else in the industry," Hazard claims. "Best Western offers the independent property the advantages of a recognized brand name and international marketing identity without the loss of individuality or operational autonomy."

9 Hazard can offer quantitative support for his assertions. In 1978, the properties in the Best Western chain earned combined revenues of \$1,133,572,000, an increase of \$208,368,000 over 1977. Of greater importance, combined net profit before taxes for all Best Western properties increased 55 percent, from \$110,975,000 in 1977 to \$171,697,000 in 1978.

10 In 1978, the board of directors approved a name change in articles of incorporation. The new corporation name, reflective of perceived future growth areas, is Best Western International, Inc.

Management at Best Western

11 Image at Best Western is a primary concern. Best Western's new single site, multilevel headquarters consists of 65,000 square feet of space. The headquarters have an obvious southwestern tone with Spanish arches and tile roofs, open courtyards, and beamed ceilings.

12 Hazard emphasizes the importance of a distinctive headquarters in stating, "We are a marketing organization in the process of proving that we are a first-class operation. When we opened here in January of 1978, we thought we would be comfortable in this working environment for 10 years, but our staff has grown very quickly. We will be adding a 67,000-square-foot expansion in the spring of 1980, including a new 10,000-foot reservation computer center."

Corporate structure

13 Best Western International is an association of member firms. The company is organized on a nonprofit basis. Should the company choose to terminate operations, all monies remaining after the liquidation of debts would be distributed to a nonprofit educational organization or charity.

14 The seven member board of directors is elected from the seven geographical districts comprising the company's operating area.

exhibit 1
Present headquarters opened in January 1978

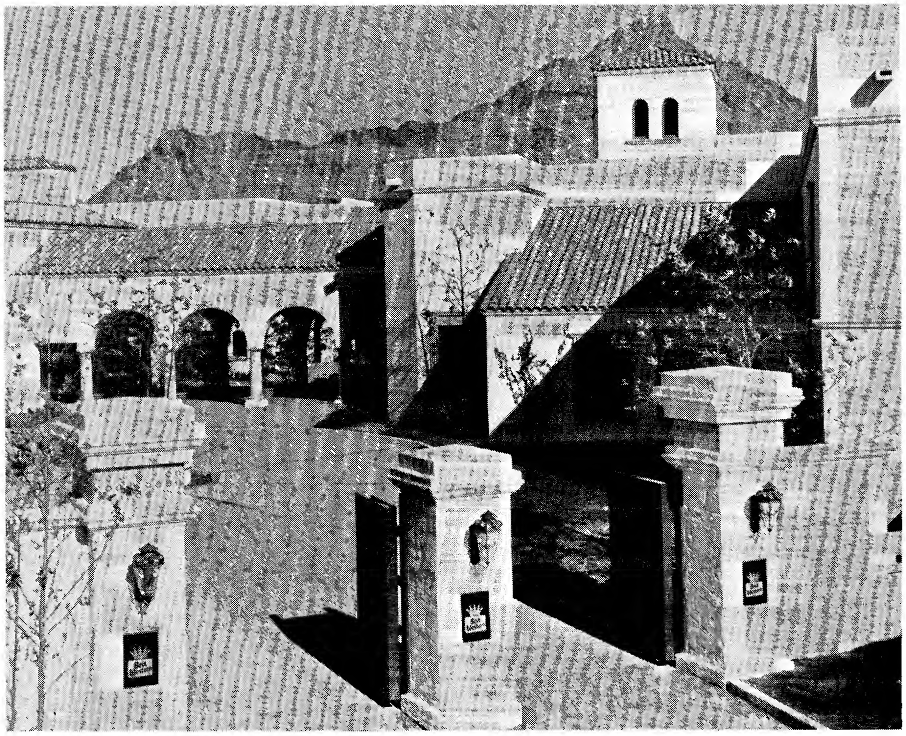


exhibit 2
Best Western Beach and Oceanaire Motel, Long Beach, California: first Western property

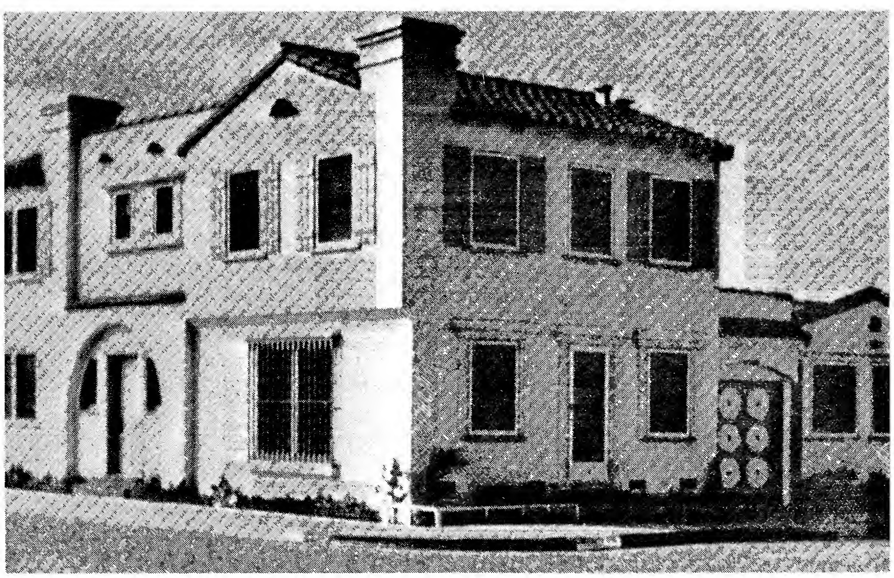
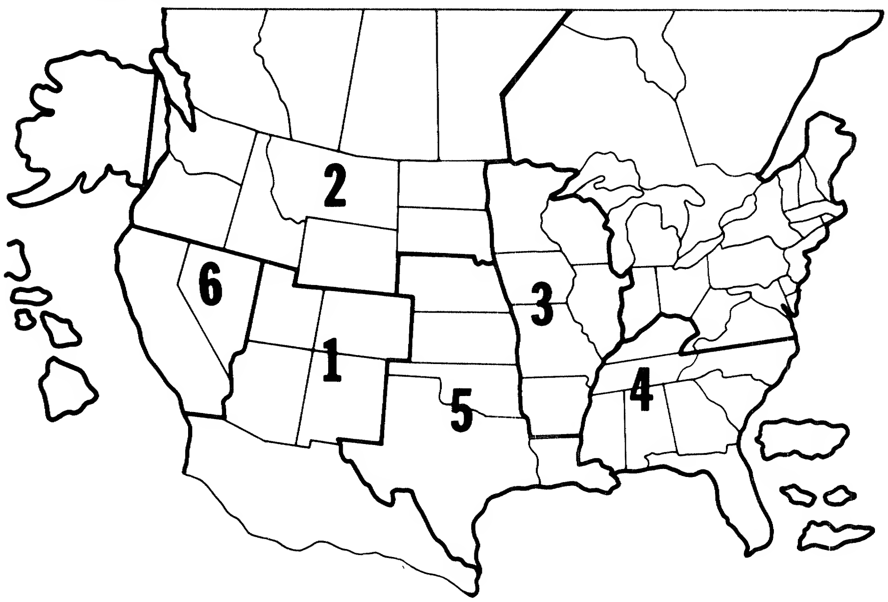


exhibit 3
Governor regions



15 Directors are elected for a term of three years and serve without compensation. The maximum number of terms that any individual may serve is two, whether or not they are consecutive. At the first regular annual meeting of the board the directors name the officers of Best Western, including president, vice president, and secretary-treasurer. The executive vice president of the company (presently Bob Hazard) is named by the board and is the chief executive officer of the company (see Exhibit 4).

Management team

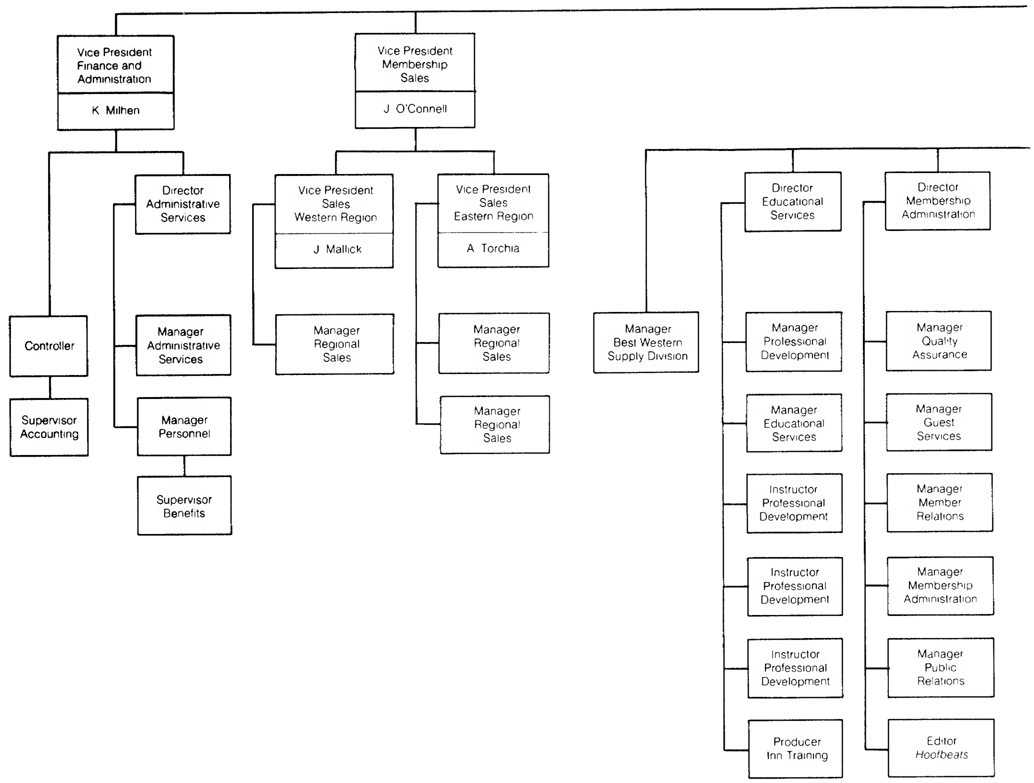
16 *Executive vice president—Robert C. Hazard.* In July 1974, Bob Hazard resigned from the vice presidency with American Express Company and assumed the role of vice president marketing with Best Western International. In 1975, Hazard was promoted to executive vice president, and in 1978 he was named chief executive officer of the company.

17 A cum laude graduate (class of 1956) of Princeton University, Hazard proved to be the guiding force behind the recent growth and improvement of the Best Western network. Some of the accomplishments attributed to Hazard include:

Guiding the expansion of the Best Western chain from 900 to more than 2,500 properties in all 50 states and 18 foreign countries.

Added 680 foreign affiliates to Best Western International.

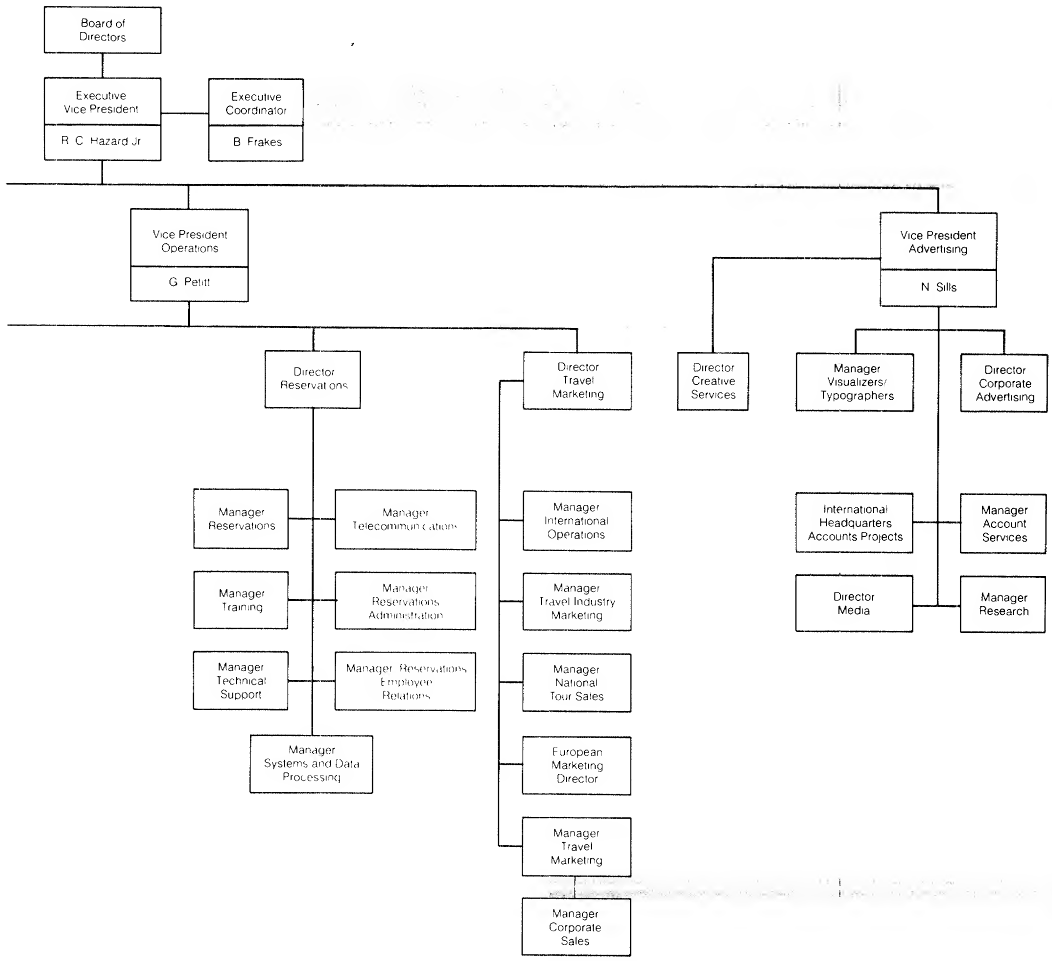
exhibit 4
Best Western management staff



Instituted a demanding quality control program which in the past four years has forced 467 properties to sever their affiliation with Best Western.

Introduced B-W Advertising, Inc., B-W Financial Services, Inc., and B-W Management Services, Inc.

18 *Vice president, operations—Gerald W. Petitt.* Jerry Petitt holds two undergraduate degrees in engineering and an MBA in marketing from Dartmouth College. Formerly a director of sales and operations with American Express, he joined Best Western International as director of reservations in 1974. He was subsequently promoted to vice president of operations, and in 1978 was named chief operating officer. Petitt designed and



directed the opening of Best Western's market and reservations center. Besides coordinating this center, Petitt is also responsible for overseeing the membership services department, quality control inspection system, educational training department, corporate communications department, marketing research department, B-W wholesale supply division, travel industry, marketing, and travel agent departments.

19 *Vice president, finance and administration—Kendall G. Milhon.* A certified public accountant and a 1967 graduate of Washburn University in Topeka, Kansas, Milhon began his career with Best Western in 1976 when he assumed the role of corporate controller. In March of 1978, he was promoted to vice president of finance and administration. Milhon manages an accounting staff of 12 and an administrative staff of 15. He directs all of

the corporate building maintenance and furniture acquisition operations. Additionally, he is directly responsible for managing Best Western's short-term cash investments and for the financial services division.

20 *Vice president, advertising—Malcolm T. Sills.* Following his graduation from the University of Denver, Malcolm Sills went to work as an office boy with a local ad agency. He quickly rose through the ranks, first as an account executive, then as an office manager, and finally as a vice president of a large Denver based advertising agency. At this junction, Sills elected to implement an entrepreneurial dream and founded his own agency, Frye-Sills, Inc. in Denver. The agency was tremendously successful, but Sills longed for yet another challenge. In 1978, he accepted the position of vice president and general manager of advertising for Best Western International. Utilizing over 30 years of professional experience, Sills completely revamped Best Western's in-house advertising operation. He was responsible for innovating Best Western's ''Media Trade Bank,'' a system that traded empty rooms for broadcast time and print space. This program matched the $3.5 million budget collected from member assessments, and provided Best Western with $7 million worth of exposure in 1979.

21 *Vice president, membership sales—John P. Matlick.* Matlick is also a relocated executive from American Express. He was formerly a regional sales director for the credit card and reservations division. In 1974, he was appointed western regional vice president for membership sales at Best Western. In July of 1979, he was promoted to head Best Western's domestic and international sales programs. Matlick developed and implemented a number of innovative marketing programs that doubled new revenues from $1 to $2 million annually.

Membership

22 As mentioned, Best Western is a nonprofit corporation owned by its members. Initial affiliation fee is set at a minimum of $2,805 (20 rooms or less) plus $25 for each additional room. Annual dues are $610 (up to 20 rooms) plus $21 per room up to 50. For properties with more than 50 rooms, the dues are $1,240 plus $7 per room over 50. Each unit owner contributes 8 cents per room per day for advertising, and one half cent per room per day to support the professional development program.

23 Finally, reservation fees include 8 cents per room per day, plus 50 cents for each room booked through the reservation center. The new ST*R terminal is the only approved reservation system. This equipment is leased for $185 per month. Until this terminal is installed, the member must belong to the ST*RLINE toll-free telephone network. The cost for this service is $1 per room per month.

24 Simply, cost of membership for a 100-unit property with 70 percent occupancy charging $22 a room-night was $10,613 in 1977. This is about one third the amount required by Best Western's major competitors.

25 Each Best Western property is independently owned and operated. The properties range in size from 14 to 900 rooms. Collectively, Best Western offers 165,000 rooms in 1,500 cities worldwide.

26 Applications for membership are forwarded to the board of directors. If the board approves, the applicant's initial membership is slated for a one-year probationary period. Memberships only apply to a single individual. If

exhibit 5
Best Western Twin Peaks Motel, Ouray, Colorado

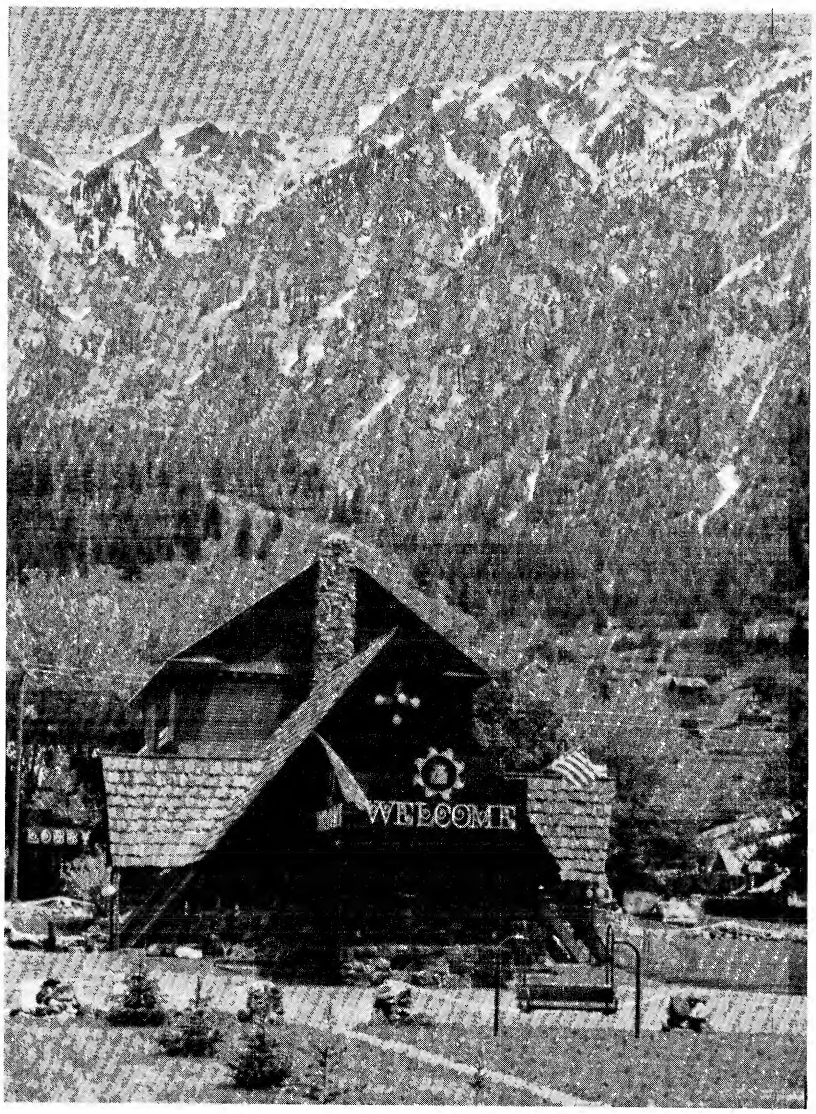


exhibit 6
Best Western Posada Inn, San Diego, California

an individual owns multiple properties, he must prepare multiple applications for membership.

Special requirements

27 While Best Western prides itself on unifying a collection of fiercely independent owner/operators, the company does require certain consistencies in all its properties. Some of these include:

1. All incoming telephone calls must be answered using the name Best Western.
2. All new members are required to send a representative to orientation seminars.
3. All members must accept reservations from travel agents and pay a minimum of a 10 percent commission on the gross room rental.
4. All members must use in each room:
   a. Guest soap with the Best Western logo.
   b. Stationery with the Best Western logo.
   c. Book matches with the Best Western logo.
   d. Drinking glasses with the Best Western logo.
   e. Best Western logo door decals.
5. Additionally, all members must choose five of the following in-room items and five of the following public areas items:

In room (select any 5 items)

a.	Key tags.	*l*.	Sani bags.
b.	Phone decals.	*m*.	Utility bag.
c.	Dial rings.	*n*.	Laundry bag.
d.	Waste baskets.	*o*.	Shoe shine cloth.
e.	Ash trays.	*p*.	Paper hand towel.
f.	Ice tubs.	*q*.	Ice scraper.
g.	Plastic tray.	*r*.	Shoe horn.
h.	Stationery bag.	*s*.	Phone book cover.
i.	Shower curtain.	*t*.	Pens or pencils.
j.	Shower cap.	*u*.	Door message cards.
k.	Toilet seat bands.	*v*.	Room number decals.

Public areas–office, lobby, or restaurant (select any 5 items)

a.	Business cards.	*l*.	Welcome mat.
b.	Folios.	*m*.	Cloth emblem.
c.	Statements.	*n*.	Mileage meter.
d.	Reservation forms.	*o*.	Restaurant checks.
e.	Purchase order forms.	*p*.	Bar checks.
f.	Post cards.	*q*.	Menu covers.
g.	Phone book cover.	*r*.	Place mats.
h.	Function binder.	*s*.	Napkins.
i.	Pens or pencils.	*t*.	Stapler.
j.	Name badges.	*u*.	Logo buttons.
k.	Travel guide holder.	*v*.	Best Western flag.

6. Finally, all Best Western properties are subject to inspection three times yearly.

28 Improved property quality control has been a major objective established by Hazard. "We have 14 inspectors that spend 365 days a year on the road. Each property is inspected on-site and judged according to our 1,000-point checklist. If a property scores 800 points or below, it is immediately placed on probation and given the choice to upgrade or be terminated." In the past four years, Best Western has cancelled 467 property memberships. During the same time period, the company received more than 11,000 membership inquiries and approved 882 new members.

Company services

29 Best Western provides a number of valuable services to its members. Some of the more notable of these support services include: (Many will be discussed at length in later sections.)

B-W Advertising, Inc.—provides a varied selection of advertising services to chain members and directs corporate advertising expenditures of $10 million. Also, this in-house agency coordinates the distribution of over 5 million copies of the Best Western Road Atlas and Travel Guide. This publication is designed to stimulate room sales and to generate repeat business.

B-W Insurance Agency—this agency is a wholly-owned subsidiary of Best Western and offers a variety of insurance packages to association members.

B-W Financial Services—provides financial assistance to all members for long-term permanent (mortgage) and interim (construction loans) financing.

Supply division—offers wholesale purchasing of furniture and supplies to Best Western members.

Reservations—the new ST*R system at Best Western reduces advance reservation time to approximately 30 seconds and is expected to quadruple bookings.

Identity—Best Western argues that the chain sign is a veritable people magnet. A 1976 survey conducted by the company indicates that 76 percent of the association's membership claim at least one fourth of their business can be credited to the sign.

Professional Institute—provides a number of training and development courses for all member motor inns, hotels, and resorts. It's easy to be the best—all you need is the best properties and the best trained people in the hospitality industry.

Financial performance

30 Revenues of $15,578,538 in 1978 were 105 percent higher than 1975. Reservations are providing an increasing proportion of revenues to the company. In 1976, reservations provided 33 percent of corporate revenues and by 1978 this figure was up to 42 percent. Of note is the fact that the company received a lesser percentage of advertising payments, membership dues, monthly dues, and affiliation fees in 1978 compared to 1976.

31 In 1976, the Best Western reservation center received 2,450,974 calls that resulted in gross room sales of $47,494,026. In 1978, reservations received 4,034,934 calls producing $106,313,705.47 in sales. The 1977 annual membership cost of a 100-room property was $7,115. In 1979, this membership cost rose to $10,947 per year.

32 Accounts payable for the years ending 1977 and 1978 indicate $384,000 payable to Telemax Corporation. In 1969 Best Western contracted with Telemax to provide a central reservation system. In 1971, Telemax terminated the contract and filed for bankruptcy. Best Western insists that Tele-

max did not perform under terms stipulated in the contract, and suspended all payments to the company. The case is now currently in litigation, and the outcome is unknown.

33 Additionally, Best Western is currently involved in a lawsuit filed by an exassociation member, alleging that his contract was unduly terminated. The plaintiff in this case is asking for a damage settlement of $1 million. The company is also involved as defendant in a number of other claims of this nature but considers these to have little potential impact on the firm's financial performance. A review of some pertinent financial information is contained in Exhibits 7 and 8.

Marketing

34 Best Western Advertising Agency, created as a full-service agency in 1976, manages B-W's multimillion dollar corporate advertising program. With 1979 billings of $6.5 million, its principal goal is to build a favorable marketing image among its many publics. National media promotions attempt to sell B-W to tour brokers, bus associations, travel agents, corporate travel planners, and the traveling public among others. National and regional television, radio, magazines, newspapers, and outdoor advertising are all used to build awareness and preference for Best Western.

35 Beyond the corporate advertising the chain offers direct, personalized advertising assistance to all members. Each district has its own account executive who serves as a direct link to the advertising department at headquarters. Account executives work with individual properties to design local advertising and marketing campaigns utilizing radio and TV, newspapers, travel agent ads, billboards, Yellow Page ads, public relation promotions, brochures, menus, letterheads, and hundreds of related projects. The account executive may call on the expertise of media research specialists, copywriters, artists, and others at the headquarters agency. Although members are charged for the service, rates are economical due to B-W's nonprofit status and group purchasing power.

36 One campaign undertaken by the association is the Media Trade Bank advertising program. In an effort to fill rooms during soft seasons and increase the efficiency of the advertising dollar, a system of exchanging unsold room-nights for advertising was devised. Each B-W property contributes room-nights equal to one half of 1 percent of the property's room-nights. This figure multiplied by the average room rate becomes the property's Media Trade Bank account, of which half is invested in corporate advertising and half in advertising the B-W property itself. Many regions vote to pool their Media Trade Bank budgets to sell the entire region with a high-impact cooperative program.

37 Media Trade Bank guests include a TV producer filming a special with crews staying in various locations while shooting, a network vice president

exhibit 7

BEST WESTERN INTERNATIONAL, INC.
Consolidated Statements of Revenues, Expenses, and Net Assets
For the Years Ended November 30, 1975–1978

	Year ended November 30,		*Year ended November 30,*	
	1978	*1977*	*1976*	*1975*
Revenues:				
Membership dues and affiliation fees	$ 4,459,060	$ 3,977,295	$3,426,995	$2,608,000
Reservations	6,528,293	4,440,956	3,159,545	2,572,433
Advertising	3,559,567	2,786,656	2,365,230	1,864,024
Purchasing commissions	386,531	289,658	305,805	358,438
Insurance commissions	38,512	85,811	62,266	—
Interest income	157,911	75,322	—	—
Other	448,664	318,040	194,856	187,909
Total revenues	15,578,538	11,973,738	9,514,697	7,590,894
Expenses:				
Advertising—				
Travel guide	1,313,110	1,056,174	914,018	993,818
Other advertising	2,686,552	1,575,427	1,523,699	1,361,757
Salaries, wages, and commissions	4,053,901	2,728,256	2,072,319	1,757,695
Payroll taxes and employee benefits	587,956	380,066	272,101	222,152
Telephone	2,240,401	1,844,600	1,428,756	1,251,660
Building and equipment rental	1,136,049	805,767	578,346	247,473
Depreciation and amortization	717,360	452,107	383,658	363,152
Travel	552,674	483,631	340,726	317,494
Postage and freight	181,960	186,727	264,477	265,716
Supplies	346,809	291,698	227,869	124,009
Professional fees	69,593	126,353	157,358	84,574
Bad debts	55,864	30,387	92,993	77,970
Directors' fees	78,800	60,428	57,200	53,444
Outside services	46,511	52,991	45,252	85,435
Maintenance	131,610	61,036	200,783	48,682
Interest	240,179	37,994	393,781	237,144
Other	761,156	537,630	205,277	20,050
Income tax expense (benefit)	(71,276)	551,817	—	—
Total expenses	15,129,209	11,263,089	9,158,613	7,512,225
Revenues in excess of expenses	449,329	710,649	356,084	78,669
Net assets at beginning of year	1,817,545	1,106,896	750,812	672,143
Net assets at end of year	$ 2,266,874	$ 1,817,545	$1,106,896	$ 750,812

on a business trip, and a group of announcers for professional rodeo. The program is expected to gain B-W upwards of $5 million in advertising annually.

38 Other marketing programs focus on special audiences; for example, a presentation at the American Bus Association (ABA) Marketplace included a corporate-sponsored breakfast for the ABA, a hospitality suite, prizes, and a series of B-W booths. A special program, Guestcheque, directed at the European market, makes it possible for members to attract European visitors and assure prompt payment in U.S. currency through a large U.S. bank.

exhibit 8

BEST WESTERN INTERNATIONAL, INC.
Consolidated Balance Sheets
For the Years Ended November 30, 1975–1978

	1978	*1977*	*1976*	*1975*
Assets				
Current assets:				
Cash	—	$ 256,000	$ 227,440	$ 547,114
Short-term investment, at cost which approximates market	784,478	—	—	—
Accounts and notes receivable (net of allowance for doubtful accounts of $85,000 in 1978 and $41,000 in 1977, $40,000 in 1976 and $48,277 in 1975)	1,271,051	644,616	512,174	444,463
Prepaid expenses and other assets	37,638	45,504	20,091	29,771
Deferred travel guide costs	1,276,272	1,313,036	1,037,905	937,271
Refundable income taxes	165,157	—	11,250	—
Total current assets	3,534,596	2,259,156	1,808,860	1,958,619
Property and equipment, at cost:				
Land	813,675	813,675	813,675	—
Building	3,308,925	3,125,333	153,235	—
Signs	3,180,234	2,731,955	2,302,199	2,055,631
Furniture and equipment	1,362,579	1,094,701	409,021	324,236
Leasehold improvements	9,933	9,933	245,553	235,688
Land improvements	34,355	26,784	—	—
	8,709,701	7,802,381	3,923,623	2,615,555
Less accumulated depreciation and amortization	2,596,336	1,953,419	1,866,659	1,800,846
Net property and equipment	6,113,365	5,848,962	2,057,024	814,709
Other assets	11,547	24,169	26,165	4,584
Total property and equipment	$9,659,508	$8,132,287	$3,892,049	$2,777,912
Liabilities and Net Assets				
Current liabilities:				
Bank overdraft	$ 406,391	—	—	—
Current installments of long-term debt	61,400	$ 70,000	—	—
Current portion of obligation under capital lease	58,875	67,200	—	—
Accounts payable and accrued liabilities	2,461,196	2,038,947	$1,534,166	$ 999,805
Travel guide expenses payable	1,143,750	1,210,754	951,437	838,270
Income taxes payable	—	360,774	—	16,806
Deferred income taxes	256,244	284,166	214,486	122,959
Deposits—membership applications	105,398	99,767	31,291	13,645
Accrued interest	6,623	12,479	—	—
Deferred income	101,936	21,057	53,773	35,615
Total current liabilities	4,601,813	4,165,144	2,785,153	2,027,100
Long-term debt, less current installments	2,505,390	1,733,305	—	—
Obligations under capital lease, less current installments	210,045	329,219	—	—
Deposits	27,903	36,629	—	—
Deferred income taxes	47,483	50,445	—	—
	2,790,821	2,149,598	—	—
Net assets	2,266,874	1,817,545	1,106,896	750,812
Commitments and contingent liability				
Total liabilities and net assets	$9,659,508	$8,132,287	$3,892,049	$2,777,912

Supply division

39 A major benefit of Best Western membership is the buying power represented by the supply division. Through vendor contracts, the division offers brand-name products at member discounts. Commissions for Best Western from the sales (over $250,000 annually) help cover operating costs of headquarters thus keeping member fees and dues lower. Vendor contracts include agreements with Pepsi Cola, Shasta, Columbia Match Company, Chevrolet, Farmer Bros. and Wechsler Coffee Companies, Fort Howard Paper Company, RCA Service Company, and Inn Keepers Supply Company. Inn Keepers Supply (IKS), the largest institutional supply company in the country, offers a comprehensive line of room furnishings and restaurant equipment as well as design services for lobby, guest rooms, and restaurant. The company also provides a variety of B-W logo items such as shower curtains, glasses, soap, ashtrays, and wastebaskets as well as a line of over 1,200 different hotel/motel forms, decals, menu covers, etc. Arrangements exist with a number of companies to provide specialty logo items including wooden signs, Kellogg breakfast menus, Rosemary Candy Company lollipops, and the ubiquitous T-shirt.

Reservations

40 B-W prides itself on having the finest modern equipment and the finest reservation staff in the industry. The brains of the property-to-property system are the more than 800 ST*R terminals installed at front desks of members all over the United States. The ST*R system has three components: a CRT display screen (cathode ray tube—similar to a television screen), a computerized keyboard for sending messages and a hard-copy printer for receiving reservations and messages from other B-W properties and the reservation center in Phoenix. Using these terminals, members are urged to make their guests' following-night reservations at another Best Western property. If no rooms are available at the guest's first choice facility, ST*R automatically displays availabilities at the nearest alternate Best Westerns. The entire process can be completed in approximately 30 seconds and the reservation information is transmitted instantaneously to the other property.

41 For members whose ST*R terminal is not yet installed, there is a toll-free ST*RLINE to the reservations center which also handles calls directly from the traveling public. Volume of calls to the reservations center increased by 1 million from 3.1 million in 1977 to 4.1 million in 1978 and was still going up rapidly in 1979. The same year showed a 35 percent increase in confirmed reservations and a 52 percent increase in gross room sales dollars while the cost of the 3.9 million room-nights sold remained exactly the same as the year before. B-W officials attribute this remarkable record to the combination of new equipment which improved efficiency of operations and its well-trained staff.

exhibit 9

42 Canadian Best Western members have their own reservations center with toll-free ST*RLINE funded, as is the U.S. line, by a $1 per room per month charge to members. As in the United States, members are urged to use the toll-free number exclusively for completely computerized and, in Canada, bilingual reservation capability.

43 Ted MacPherson, manager of B-W telecommunications department, describes ambitious plans for the future. "Telecommunications includes all means and methods of transmission of information such as telephone, telex, teletype, video, microwave, cable, and satellite. The possibilities of satellite transmission of information to members include in-room movies, cleaner data transmission, and a reduction in output errors as well as reduction of dependence on telephone lines. Additionally, we would like to expand the overall capabilities of Best Western utilizing advanced technology to improve efficiency in reservations and communications while minimizing costs."

Professional Institute

44 "In a labor-intensive business, the competitive edge between lodging chains for 'the best' is very thin. We need to develop our people's talents and promote and nurture their dedication to excellence." With these words

Gerald Petitt, operations vice president and chief operating officer for Best Western explains the philosophy behind headquarters' extensive educational services. Each year four regional conferences are scheduled as 2½-day educational and training sessions. Business spiced with recreation is provided at resort conference centers with facilities for an expected 500 attendees. In 1979, meetings were scheduled at Hilton Head, North Carolina; Colorado Springs; Monterey, California; and Lake of the Ozarks, Missouri. Each year's meetings focus on one topic of particular interest to members. One year's attention is devoted to housekeeping; another year, front desk or financial management will serve as the theme. Meetings are planned on a five-year cycle to facilitate members' plans and scheduling.

45 B-W's new headquarters in Phoenix, Arizona, serve as a focal point for an intensive, on-going member education program. George Ross, professional communicator, heads the educational services department which develops, supervises, and conducts the continuous training programs both in Phoenix and in numerous locations around the country.

Professional development program

46 This program is responsible for training new members and keeping B-W members abreast of innovations in the lodging industry. Four full-time instructors conduct programs designed to enhance service and cut costs for the member innkeeper. A professional development program catalog, distributed annually, provides a description of facilities available, a calendar of training sessions, and the location and course description for all programs including remote sessions, round-up, area meetings, and orientation seminars. Courses offered include:

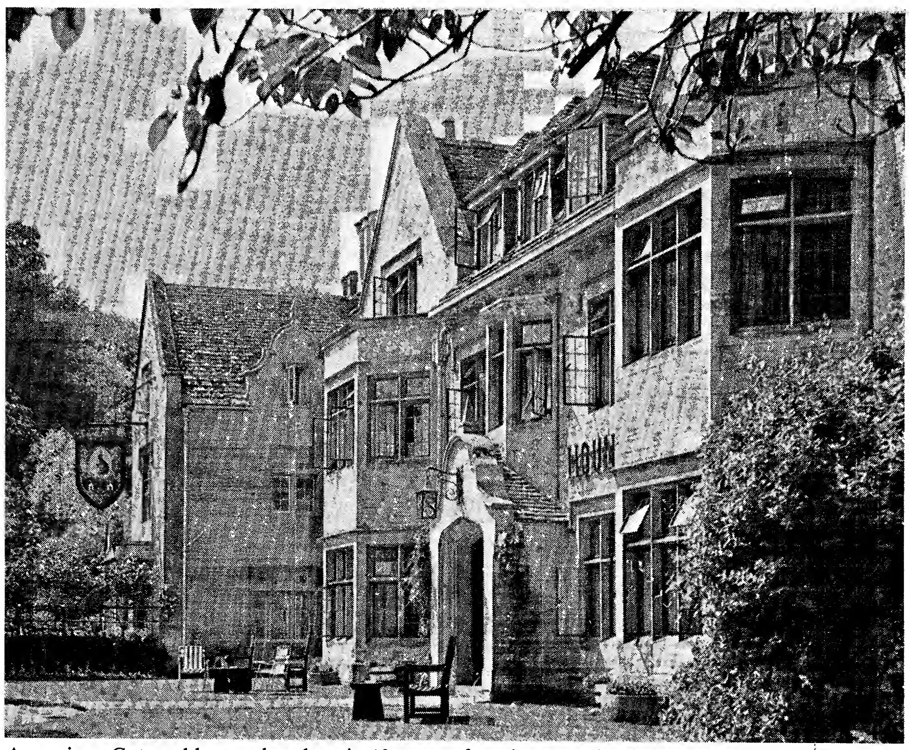
1. The management development course—designed for personnel directly involved with on-site management (e.g., general manager, front desk manager, executive housekeeper, etc.).
2. Fundamentals of hotel/motel operations course—designed for the new owner who has never owned a property, has no experience in the industry.
3. Orientation seminar course—a mandatory program for all new B-W members.
4. Front office management course—designed to teach or reinforce basic skills for the general manager, front office manager, and assistant.
5. Personnel management course—designed to help B-W operators deal more efficiently with their employees, focus on government regulations, record keeping, and employment requirements.
6. Food and beverage management course—designed for personnel directly or indirectly involved in food and beverage operations (e.g., general manager, food and beverage manager, restaurant manager and assistant, purchasing agent, etc.).

47 Attendance at courses is traditionally high. For example, the management development program drew 1,000 B-W owners and operators during 1978. A shortened, intensive version of the normally five-day course was taken to remote locations during 1979. To make attendance easier for more operating personnel, three-day sessions were held in Georgia, Minnesota, and West Virginia.

48 A section of headquarters, designated a learning laboratory with mock-ups of all room types found in the hospitality environment, doubles as a studio for production of training films. Each B-W property maintains an inn-training film library designed to supplement each manager's on-site training efforts. New film strips are mailed regularly from headquarters as a reflection of B-W's belief that first-class facilities and service can only be accomplished through a comprehensive and professional training program.

49 The cost of attending programs is paid by all members through a monthly educational assessment. Individual students pay for their own transportation, room and board, and a book and materials fee.

exhibit 10



A gracious Cotswold stone hotel set in 10 acres of garden woodland, the Best Western Hare and Hounds Hotel is convenient to Bristol, Gloucester, Cheltenham, and Bath. Guests at the hotel can choose from old world garden strolls, squash and tennis on the Hare and Hounds' own courts, or the warmth and charm of a log fire at any of the hotel's three pubs. It is one of 108 interchange hotels now affiliated with Best Western, the world's largest lodging chain.

International operations

50 In late October of 1979, Best Western executives from around the world convened in London, England. Those present at the conference included the board of directors from the United States, the chairman of each of the international affiliate organizations, and the chief executive officers and key personnel from each country. The meetings were called to set policies and determine expansion directions for the organization on a worldwide basis.

51 Bob Hazard notes that, "Six years ago, Best Western had no international affiliates. Today, it has properties in 18 countries." Foreign affiliates include a 135-member hotel group in England-Scotland-Wales, 80 Best Westerns in New Zealand, as well as properties in Canada, Mexico, Australia, southern Africa, Ireland, France, Austria, Denmark, Sweden, Finland, Luxembourg, Andorra, and the Caribbean.

52 In an effort to increase Best Western's share of the international travel market, a new director of marketing for Europe was recently appointed. Brendan Ebbs, experienced in both the U.S. and European travel industry, intends to concentrate on three aspects of international operations. "My first priority is to channel visitors from Europe into Best Western properties in North America. Next, I'll be aiding Best Westerns on this side of the ocean by helping make sure that U.S. visitors stay in Best Western's European affiliates. And, of course, I'll be seeking new groups of quality European hotels to join Best Western."

Best Western International, Inc. (B): Update—1981

53 As it moves into the 1980s, Best Western has emerged as the most aggressive suitor for Holiday Inns' share of the lodging industry market. In total number of sites, Best Western has surpassed Holiday Inns. By the end of 1980, Best Western had over 2,700 locations to Holiday Inns' 1,755 company-owned and franchised units. These were the only two U.S.-based lodging chains to top $1 billion in 1979 lodging sales. Best Western topped $1.5 billion in system-wide 1980 revenues. Exhibits 1, 2, and 3 provide updated information on Best Western's financial performance and position through November 30, 1979. Combined net profit before taxes for all Best Western properties has risen from $30 million in 1975 to over $205 million in 1979.

Quality control

54 Best Western has placed increasing emphasis on standardized quality control across its rapidly growing system. Claiming to have "the toughest quality control inspection system in the lodging industry," each Best Western property is visited twice a year by one of 14 full-time inspectors and rated in terms of facilities, maintenance, and cleanliness on a stringent 1,000-point rating system. More than 338 mismanaged or worn-out properties have been terminated in the last three years for failure to meet Best Western's increasingly tougher quality control standards.

55 As an indicator of its quality lodging emphasis, Best Western's goal is to have the top-rated property in every market area by 1989. Currently, Best Western has the top-rated property in 532 cities in the United States and Canada according to *Mobile Travel Guide*.

56 To further this commitment, B-W supply division (a wholly-owned subsidiary) has established purchasing relationships with major manufacturers to supply Best Western affiliates with a wide variety of high-quality products at low prices (up to 30 percent discounts).

Future business: The foreign traveler

57 As he looked toward the 1980s, Robert Hazard, Best Western's chief executive officer (CEO), sees the foreign traveler as the answer to gasoline short-

This update was prepared by Richard Robinson, University of South Carolina.

exhibit 1

BEST WESTERN INTERNATIONAL, INC. AND SUBSIDIARIES
Consolidated Statements of Revenues, Expenses and Net Assets
For the Years Ended November 30, 1978–1979

	1979	*1978*
Revenues:		
Membership dues and affiliation fees	$ 4,825,205	$ 4,459,060
Reservations	10,467,046	6,528,293
Advertising	3,960,314	3,559,567
Purchasing commissions	449,568	386,531
Insurance commissions	65,346	38,512
Interest income	318,048	157,911
Other	730,133	448,664
Total revenues	20,815,660	15,578,538
Expenses:		
Advertising:		
Travel guide	1,354,919	1,313,110
Other advertising	3,052,839	2,686,552
Salaries, wages, and commissions	5,138,152	4,053,901
Payroll taxes and employee benefits	912,733	587,956
Telephone	2,725,704	2,240,401
Building and equipment rental	2,592,042	1,136,049
Depreciation and amortization	801,278	717,360
Travel	771,817	552,674
Postage and freight	202,997	181,960
Supplies	503,226	346,809
Professional fees	143,576	69,593
Bad debts	80,000	55,864
Directors' fees	95,025	78,800
Outside services	44,003	46,511
Maintenance	159,713	131,610
Interest	263,855	240,179
Other	867,180	761,156
Income tax expense (benefit)	263,299	(71,276)
Total expenses	19,972,358	15,129,209
	843,302	449,329
Revenues in excess of expenses		
Net assets at beginning of year	2,266,874	1,817,545
Net assets at end of year	$ 3,110,176	$ 2,266,874

ages, prices, and other threats to the U.S. lodging industry. When gasoline hits $2 a gallon, according to Hazard, auto driving will fall by 17 percent.[1] In a 1980 interview with *Forbes,* Hazard said: "We must move boldly and decisively before changing conditions drop our occupancy and profits."[2] Instead of following Holiday Inns into casino gambling, Hazard's answer has been to make a major effort to attract foreign travelers. He expects the

[1] Best Western's major competitor, Holiday Inns, flatly disagrees. Their research suggests no real change in *highway* auto travel at $2 a gallon prices. Other studies, like the American Petroleum Institute, agree with Best Western.

[2] "Somebody Must Be Wrong," *Forbes,* April 14, 1980, p. 86.

exhibit 2

BEST WESTERN INTERNATIONAL, INC. AND SUBSIDIARIES
Consolidated Statement of Changes in Financial Position
For the Years Ended November 30, 1978–1979

	1979	*1978*
Financial resources were provided by:		
Revenues in excess of expenses	$ 843,302	$ 449,329
Items which do not use (provide) working capital:		
Depreciation and amortization	801,278	717,360
Provision for noncurrent deferred income taxes	247,555	(2,962)
Loss on retirement of property and equipment	2,006	11,695
Other	—	(6,587)
Working capital provided by operations	1,894,141	1,168,835
Proceeds from long-term borrowings	—	796,695
Proceeds from sale of property and equipment	46,648	—
Other	—	23,672
Total resources provided	1,940,789	1,989,202
Financial resources were used for:		
Purchase of property and equipment	1,005,251	1,004,508
Computer softward development costs	544,196	—
Current installments and repayment of long-term debt	61,512	24,610
Current installments and repayment of obligations under capital lease	56,005	119,174
Other	46,461	2,139
Total resources used	1,713,425	1,150,431
Decrease in working capital deficit	$ 227,364	$ 838,771
Analysis of (increase) decrease in working capital deficit:		
Cash	$ —	$ 256,000
Short-term investments	(220,362)	(784,478)
Accounts and notes receivable	(534,170)	(626,435)
Prepaid and other expenses	(60,289)	7,866
Deferred travel guide costs	1,113,679	36,764
Refundable income taxes	165,157	(165,157)
Bank overdraft	(294,478)	406,391
Current obligation under capital lease	10,528	(8,325)
Current installments of long-term debt	5,600	(8,600)
Accounts payable and accrued liabilities	619,455	422,249
Travel guide payable	(1,143,750)	(67,004)
Income taxes payable	328,125	(360,774)
Deferred income taxes	(339,666)	(27,922)
Deposits—membership applications	20,676	5,631
Accrued interest	18,210	(5,856)
Deferred income	83,921	80,879
Decrease in working capital deficit	$ (227,364)	$ (838,771)

devalued dollar to attract increased foreign tourism and foreign businesses that will replace declining American travelers' dollars.

58 By early 1980, Best Western had recruited 852 new international affiliates in 18 countries. In 1980, Best Western added over 320 international affiliates to that number, including 28 West German properties. At present, 35 percent of Best Western membership is international. Hazard felt international vis-

exhibit 3

BEST WESTERN INTERNATIONAL, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
For the Years Ended November 30, 1978–1979

	1979	*1978*
Assets		
Current assets:		
Short-term investments, at cost, which approximates market	$ 1,004,840	$ 784,478
Accounts receivable (net of allowance for doubtful accounts of $130,685 in 1979 and $85,000 in 1978)	1,805,221	1,271,051
Prepaid expense and other assets	97,927	37,638
Deferred travel guide costs	162,593	1,276,272
Refundable income taxes	—	165,157
Deferred income taxes	83,422	—
Total current assets	3,154,003	3,534,596
Property and equipment, at cost:		
Land	813,675	813,675
Building	3,461,062	3,308,925
Signs	3,570,290	3,180,234
Furniture and equipment	1,669,257	1,362,579
Leasehold improvements	4,659	9,933
Land improvements	34,355	34,355
Total property and equipment, at cost	9,553,298	8,709,701
Less accumulated depreciation and amortization	3,284,614	2,596,336
Net property and equipment	6,268,684	6,113,365
Deferred costs and other assets	598,799	11,547
Total assets	$10,021,486	$9,659,508
Liabilities and Net Assets		
Current liabilities:		
Bank overdraft	$ 111,913	$ 406,391
Current installments of long-term debt	67,000	61,400
Current obligation under capital lease	69,403	58,875
Accounts payable and accrued liabilities	3,080,651	2,461,196
Travel guide expenses payable	—	1,143,750
Income taxes payable	328,125	—
Deferred income taxes	—	256,244
Deposits—membership applications	126,074	105,398
Accrued interest	24,833	6,623
Deferred income	185,857	101,936
Total current liabilities	3,993,856	4,601,813
Long-term debt, less current installments	2,443,878	2,505,390
Obligations under capital lease, less current installments	154,040	210,045
Deposits	24,498	27,903
Deferred income taxes	295,038	47,483
Net assets	3,110,176	2,266,874
Commitments and contingent liability	—	—
Total liabilities and net assets	$10,021,486	$9,659,508

itors more familiar with the Best Western name would more likely choose the U.S. Best Western properties. He feels Best Westerns' individualized properties will be an added advantage:

Rooms appealing to foreigners are not those favored by Americans. Stan-

dardized packaging and cookie-cutter rooms will lose their appeal. They will be replaced by properties offering individual personality and atmosphere.[3]

59 As further evidence of this commitment to the foreign traveler, Best Western is the first lodging chain to provide multilingual directories, as shown in Exhibit 4.

exhibit 4
Best Western directory symbols

	Español	Deutsch	Français
Restaurant on premises or within 500 feet	Restaurante en el establecimiento o a menos de 150 metros	Restaurant direkt auf Best Western Grund oder in hochstens 150m Entfernung	Restaurant dans l établissement ou au plus à 150 mètres
Cocktail lounge on premises or within 500 feet	Bar salón en el establecimiento o a menos de 150 metros	Cocktail Bar im Hause oder in hochstens 200m Entfernung	Bar avec salon dans l établissement ou au plus à 150 mètres
Swimming pool	Piscina	Swimming pool	Piscine
Indoor swimming pool	Piscina interior	Swimming pool im Hause	Piscine couverte
Banquet/meeting facilities*	Salones para reuniones o banquetes*	Gesellschafts- und Konferenzräume*	Salons pour banquets ou réunions*
Children under 12 free in same room with parents*	Se admiten gratis los niños de hasta 12 años de edad que compartan la misma habitación con los padres	Freie Ubernachtung fur Kinder unter 12 Jahren die zusammen mit den Eltern schlafen*	Gratuit pour enfants au dessous de 12 ans partageant la chambre de leurs parents*
Facilities for handicapped	Instalaciones especiales para inválidos	Einrichtungen fur Behinderte	Installations spéciales pour handicapés
Fly/Drive packages	Excursiones combinados avión/automóvil	Kombinierte Flug-Mietwagen Angebote	Excursions avion/automobile
Pets allowed	Se permiten animales domésticos	Tiere erlaubt	Animaux domestiques autorisés
Pets limited*	Numero de animales permitidos	Nicht alle Tiere erlaubt	Nombre limité d animaux *
No pets allowed	Se prohiben los animales	Hunde verboten!	Les animaux ne sont pas permis
Higher rates for special events or holidays	Tarifas más altas en días de fiesta o acontecimientos especiales	Zuschlage bei besonderen Anlässen oder an Feiertagen	Tarifs plus élevés les jours fériés ou pendant les périodes de vacances

	Español	Deutsch	Français
Senior Citizen rates*	Tarifas especiales para retirados	Ermaßigungen fur Senioren	Tarifs spéciaux pour retraités*
Live entertainment	Entretenimiento en vivo	Live Unterhaltung	Cabaret attractions
In-room movies available	Peliculas disponibles en su propia habitación	Kino	Diffusion vidéo de films dans votre chambre
Golf course nearby	Campo de golf cercano	Golfanlage in der Nahe	Terrain de golf à proximité
Tennis courts nearby	Campo de tennis cercano	Tennisanlage in der Nahe	Terrain de tennis à proximité
Sauna	Sauna	Sauna	Sauna
24 hour airport courtesy car service	Servicio de automóvil para transporte al aeropuerto 24 horas al dia	Auto Service zum Flughafen rund um die Uhr	Voiture navette gratuite entre l aéroport et l hotel 24 heures sur 24
Limited airport courtesy car service*	Limitaciones del transporte al aeropuerto*	Auto Service zum Flughafen, jedoch zeitlich begrenzt	Limitation de la navette gratuite aéroport hotel
Horseback riding nearby*	Se puede montar a caballo cerca*	Reitmoglichkeiten in der Nahe*	Randonnée à cheval approximitée*
Fishing nearby*	Se puede pescar cerca*	Angelmoglichkeiten in der naheren Umgebung*	Pêche autoriser approximitée*
Skiing nearby*	Se puede esquiar cerca*	Gelegenheit zum Schilaufen in der Nahe*	Piste de ski approximitée*
Playground	Campo de recreo	Spielplatz	Terrain de jeu

*(Contact property for specific information.)

*(Póngase en contacto con el establecimiento correspondiente para obtener información más especifica.)

*(Setzen Sie sich mit Best Western in Verbindung zwecks naherer Informationen.)

*(Pour tout renseignement complémentaire, contacter l'établissement correspondant.)

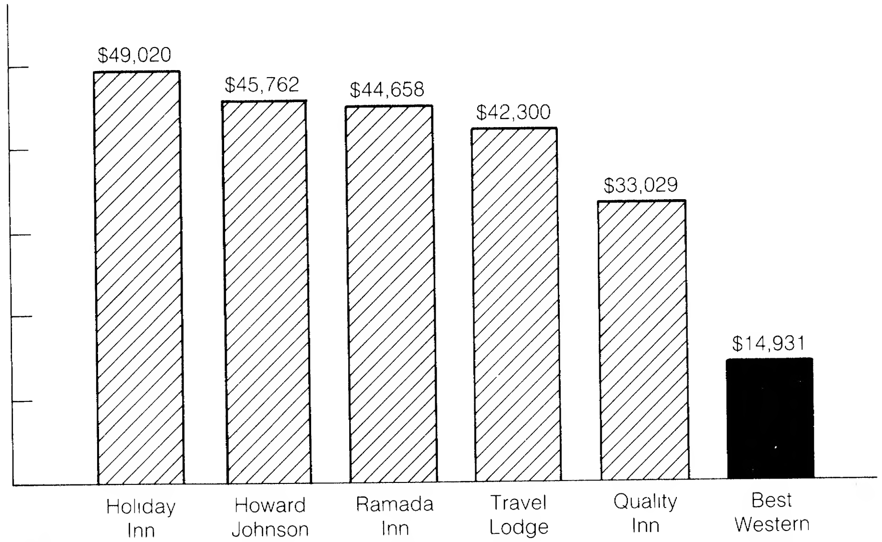
[3] Ibid.

exhibit 5

Best Western's membership concept: Annual fee comparison

Because Best Western is the only nonprofit hotel corporation in the world, its affiliates are provided with the most effective marketing, operational, and training programs in the industry at a cost substantially below those of any other major chain.

Yet the decision to join the world's largest lodging chain should be based on more than just reduced affiliation expenditures. The true value of Best Western International cannot be measured in terms of decreased membership fees, but rather in its ability to generate substantial new business, increase profits for its affiliates, and allow complete operational independence.



* Estimated costs for a 100-room hotel grossing $6,650 per room per year, based on latest available information.

The Future

60 Best Western is currently the fastest growing chain in the lodging industry. Facing increasingly competitive conditions, Best Western feels its unique concept as a nonprofit association of independent lodging operators will lead it to the top (see Exhibit 5).

61 In 1981, Best Western sought this goal with new leadership. Robert Hazard left Best Western to become CEO at Quality Inns. Rumors suggested the departure was prompted by a sizeable offer from Quality Inns as well as increasing pressure from Best Western's independent membership for a greater voice in key decisions being made by Hazard.

case 32

Congress Motel and Brown's Overnite Trailer Park (B)

1 Calvin Brown had a serious decision to make as he headed into the spring 1978 travel season. Congress Motel's 1977 performance had been the worst in almost 10 years. Room revenue had fallen from over $73,000 to under $40,000 in 1977, even with room rates up over 50 percent during the same period. And the first four months of 1978 were virtually identical to 1977's low levels. Finding it increasingly difficult to keep Congress Motel current in its financial obligations, Brown pondered two choices:

1. Find a way to sell or get out of his business and start a new career.
2. Endure the stress of the current situation and try to stabilize and hopefully revitalize his motel/campground business.

2 At his banker's urging, Brown had been talking with consultants from the Small Business Development Center, College of Business Administration (University of Georgia) since October 1977. These consultants were assisting Brown in examining his Congress Motel dilemma through a systematic planning effort described in Exhibit 1. Below are excerpts from the consultants' report on the situation as of their initial visit with Brown:

3 Congress Motel facing severe cash flow problems . . . mainly a decline in sales and low motel occupancy . . . Brown attributes problems to gas crisis of 1974 and growth in I-75 motel chains . . . very focused on monthly expenses . . . trying to do things like cut grass, paint billboards, and repair air conditioners to save money . . . little emphasis (by Brown) on dynamics of the south I-75 travel industry other than his immediate interchange . . . minimal attention to the campground's potential—no occupancy records kept . . . (Brown) hopes we (SBDC) can get him gimmicks to increase motel occupancy.[1]

4 With the help of the student consultants, Brown was encouraged to analyze his situation in a structured manner similar to the analysis phase in Exhibit 1. Exhibit 2 presents the results of this analysis. Brown (with the consultants' assistance) identified key strengths and weaknesses of his busi-

This case was prepared by Richard Robinson, University of South Carolina.

In order to best utilize this (B) case, you should first read and analyze the Congress Motel and Brown's Overnite Trailer Park (A) Alternate Cohesion Case provided earlier in this book.

[1] University of Georgia SBDC, Athens, Georgia, case file no. 081, *Congress Motel*.

exhibit 1
Crisis planning at Congress Motel

Phase I analysis	*Phase II alternative/choice*	*Phase III implement/monitor*
1. Internal focus—evaluation of firm's strengths and weaknesses in finance, marketing, facilities, location, management, services or product, pricing, costs, customer relations, image, etc.	1. Identification of critical internal weaknesses or external threats that must be met before other action can be taken.	1. Commit actions to priority and time table.
2. External focus—evaluation of opportunities and threats in particular industry, regional market, sources of capital, economy, technology, and regulation.	2. Identification of unusual strengths or external opportunities that must quickly be exploited.	2. Begin efforts toward most critical first.
3. Competition focus—evaluation of firm's comparative standing with direct competitors—comparison of strengths and weaknesses from above relative to specific competitors within identified external situation.	3. Brainstorming generation of ideas/actions that maximize internal strengths to meet external opportunities and minimize impact of internal weaknesses or external threats.	3. Continue brainstorming discussion with key info sources—partner, banker, accountant, competitors, supplies, SBDC.
	4. Move from general to specific very early in process.	4. Identify effectiveness measures of individual actions—like occupancy rate.
	5. Identify simple alternatives.	5. Systematically monitor measures.
	6. Choose actions.	

ness. Data were sought indicating general or specific opportunities and threats within his relevant environment.

5 This analysis or general forecasting activity led to the development of a simple planning matrix shown in Exhibit 3. The purpose of the planning matrix was to focus Brown on developing specific actions or strategies that (1) maximized utilization of his strengths, (2) avoided basing strategies on critical weaknesses, (3) targeted potential opportunities on which to focus his strengths, and (4) minimized the impact of major threats. The actions and strategies developed are shown inside the Exhibit 3 matrix.

6 This analysis provided the basis for Brown to decide whether he should try and get out of the business or endure and try to turn the business around. Brown and the student consultants surmised three options:

1. Continue to operate the business (or close it if occupancy drops below 30 percent) and put all of Brown's efforts into selling an ongoing concern or liquidating the property and equipment if initial buyers were scarce.

exhibit 2
Phase I: Analysis

A. Internal focus.
1. Business names/image: *motel* conveys mom & pop image; *Overnite Trailer Park* conveys same; *Congress* not helpful in terms of anti-Washington atmosphere.
2. Prices: second lowest motel price ($8 single) and *lowest* campground price within 150-mile radius.
3. Cash position: very poor/minimal working capital.
4. Billboards: cost—major advantage; own all boards; number of signs (12) a major advantage; sign copy—disadvantage, done by Brown to save money and price advertised on only 4 out of 12.
5. Location: semidying interchange, 1 gas station, 2 miles to a restaurant, but quiet and serene.
6. No restaurant: too costly.
7. Condition of property: motel relatively new—1966; campground reasonably scenic—but laundry and showers need cleanup.
8. Extras: swimming pool, miniature golf, 3-acre lake, picnic tables.
9. Campground: 26 of the 34 spaces with water/electrical/sewage hookups, other 8 with water for tent campers; all paid for in 1967.
10. Breakeven point: motel—52% occupancy, campground—18% occupancy.

B. External focus.
1. South I-75 travel industry characteristics (Atlanta to Florida):

	1976	*1980*	*1990*
Average daily volume:			
Cars	26,000	36,000	44,600
Recreational/vacation	8,840	12,240	14,960
Number of motel rooms available		8,280	9,108
Number of cars desiring motels		6,487	7,779
Average occupancy rate—south I-75 motels		78%	85%
Number of campsites (RV) available		840	1,680
Number of vehicles desiring camping		1,469	2,244
Average potential occupancy rate—south I-75 campgrounds		175%	133%
	1967	*1975*	*1977*
Average number of days in Georiga:			
1-2 days	68%	51%	50%
3 or more	32	49	50
Type accommodations desired:			
Motel	66	53	50
Campground	1.8	10.5	12.8

2. Name recognition according to trade magazines: *Inn* is more recognized as clean, safe, and desirable than *motel*; *campground* more recognized as RV area than any other.
3. SBA or bank loan availability: not much receptivity.
4. SBA loan repayment holidays: with good reason, SBA-guaranteed loan payment can be postponed for 6 months and renewed for subsequent 6 months.

' Available through state of Georgia welcome center surveys.

2. Continue to operate the business but cut overhead and excess operating capacity to a minimum.
3. Continue to operate the business by changing its image and placing future emphasis on the campground side of the operation.

7 Brown chose the third option. The first option was eliminated primarily

exhibit 3

Phase II: Alternatives and key considerations

<table>
<tr><th rowspan="2"></th><th colspan="5">Opportunities</th></tr>
<tr><th>Increased I-75 traffic volume</th><th>Increased demand for camping</th><th>Lack of camping facilities available</th><th>Cost of competitors getting into camping business</th><th>Increased days in Georgia</th></tr>
<tr><td>Strengths: Prices and low breakeven point</td><td>Increase in number of budget-conscious travelers</td><td colspan="3">Key advantage: Current prices of $3.25 per day for campsite can be raised by $1 and still be below south I-75 average</td><td></td></tr>
<tr><td>Number (12) and costs of billboards</td><td>Repeat exposure</td><td colspan="3">Key advantage: Ability to get good advertising exposure about campground for interstate traveler at minimal long term cost to Brown</td><td></td></tr>
<tr><td>RV campground facility paid for</td><td></td><td colspan="3">CRITICAL: Obvious strategic advantage matching unused strength with sizable market opportunity</td><td></td></tr>
<tr><td>Extras: (pool, miniature golf, lake, picnic)</td><td>Important to more travelers</td><td colspan="3">Advantage: Attractive to camper families</td><td></td></tr>
<tr><td>WEAKNESSES: Name and image—motel and trailer park</td><td>Need to improve for repeat business</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Billboard copy
Hand painted
Wording
Price and campground</td><td></td><td></td><td></td><td></td><td>Emphasize recreational extras</td></tr>
<tr><td>Cash position
Lack of working capital</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>No restaurant</td><td>More travelers not concerned, possibly</td><td>Often self-contained; don't need restaurant</td><td></td><td></td><td>Hurts likelihood of stayovers; must deal with somehow</td></tr>
<tr><td>Lost AAA listing</td><td>Same as above</td><td></td><td></td><td></td><td></td></tr>
</table>

		Threats:			
Cost of signs on I-75 south	Possible SBA six-month loan repayment holiday	Over competitive motel industry on I-75 south	Name recognition and image associated with *motel*	Name recognition and image associated with *trailer park*	SBA bank receptivity to additional loans or refinancing
		Brown's break-even point offers strategic advantage			
Key advantages: Exploit use of all these (12) signs					
		CRITICAL: Place emphasis on campground facility and on motel price			
		Important: Chain-type extras at no extra cost—emphasis on signs			
	CRITICAL: Source of working capital to change signs, image, and make improvements	*Important:* Target market family, budget-conscious, outdoor-oriented travelers	*CRITICAL:* Change names to reflect current consumer preference for *Inn* and *Campground*. *Lakeview* projects image attractive to recreational vacationing traveler		
	CRITICAL: Source of cash flow to change signs		*CRITICAL:* Signs must be professional, simple, standardized with equal billing for campground to improve *image*		
	CRITICAL: Allows $748/month additional cash flow to pay for changes				*Important:* Avoid wasting time along this route
		Distinct disadvantage: especially at motel. Try to make local discount arrangement			
					Sell portable rooms—get back AAA and reduced debt

because Brown had informally entertained buyer inquiries for several years, never receiving an offer sufficient enough for Brown "to get money out of the business." Gradual liquidation would be difficult to accomplish and it was unlikely to generate the necessary revenue to pay off all loans and retain ownership of Brown's house—currently a part of the business's assets.

8 The second option was rejected, after lengthy consideration, because Brown was already operating with as little overhead as possible. In essence, this option has been Brown's strategy since 1974 and it had done little good.

9 To pursue the third option, Brown required more cash than the business was currently generating. Unfortunately, given the business's poor performance over the last four years, his banker refused to loan any additional money even when presented a thorough turnaround plan by Brown and the student consultants.

10 Brown and the SBDC consultants concluded that changing the name of his business was the critical component of a turnaround strategy. The name change, they concluded, had to use current terminology (*inn* and *campground*) to increase traveler interest and, at the same time, place greater emphasis on Brown's camping facilities. The camping facilities were his greatest strength in light of current market conditions.

11 After considering several names, Brown and the consultants decided on Lakeview Inn and Campground. This name, it was felt, communicated a scenic property that should attract the camping travelers' interest. But to implement this change required at least $210 per sign for Brown's 12 billboards and two on-site signs.[2] Furthermore, it would have to be done immediately so as not to confuse potential interstate customers.

12 Since the business itself would not generate the necessary $3,000 at current levels for at least one year, outside financing was critical. Brown and the student consultants determined the SBA-loan holiday would be the only realistic means of providing the necessary working capital to rapidly redo the signs. With a reprieve on the two SBA loans, Brown would have an additional $748 per month cash flow. The sign company that would paint the signs was amenable to a 90-day repayment schedule if Brown could arrange the SBA-loan holiday.

13 Exhibit 4 shows the priorities that were established to implement this turnaround strategy. With the help of his banker, the SBA-loan holiday was approved effective June 30, 1978. The billboard changes were completed in July 1978, as shown in Exhibit 5. The fourth and fifth priorities were implemented at the same time.

---

[2] This price was quoted for professional repainting as mentioned in the (A) case. While Brown had been repainting his signs to save money, it was deemed critical by the consultants that rebuilding the business's *image* necessitated professional repainting since Brown's only communication medium was highway billboards.

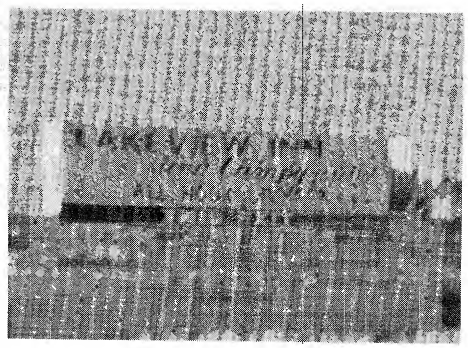
exhibit 4
Phase III: Strategic priorities in Congress Motel's turnaround strategy

First:	Cash flow—negotiate six-month SBA loan holiday with additional six-month option—necessary to generate cash flow to implement other actions—represents two SBA loans with $748 total monthly payment.
Second:	Change name to Lakeview Inn and Campground.
Third:	*Professional* repainting of all billboards using standardized copy and color scheme—emphasis on price, campground facilities, and extras—equal billing to campground.
Fourth:	Raise prices of campground facilities by $1 to coincide with name change.
Fifth:	Improvement of condition of motel/campground property—campground laundry and showers having first priority.
Sixth:	Consider alternative use of portable rooms which caused AAA rating loss.
Seventh:	Investigate arrangement with local country restaurant for discount arrangement for motel/campground guests.

exhibit 5
Picture of an interstate billboard

Before

After (July 1978)



Two Years at Lakeview Inn and Campground

14 The remainder of 1978 showed a dramatic improvement in campground occupancy compared to Brown's estimates of occupancy for the same period the previous year (an estimated 300 percent improvement). While tapering off somewhat from this initial 300 percent estimated improvement, campground occupancy and revenue have improved considerably over pre-1978 levels as shown in Exhibit 6. Motel revenue has not improved significantly. Exhibit 6 provides income statements for 1978 through 1980. Exhibit 7 provides the balance sheets for the same time periods.

15 In 1979, Brown was able to sell the eight portable motel rooms for $15,000. The proceeds were used to pay off the smaller SBA loan—originally made for these units. In addition, Brown sold about $5,000 worth

exhibit 6

LAKEVIEW INN AND CAMPGROUND
Income Statement
For the Years 1978–1979

	1980	*1979*	*1978*
Income:			
Room rent	$38,539.00	$38,255.00	$42,479.00
Campground rent	18,312.75	16,305.90	15,555.85
Sign rent	761.78	410.00	1,410.00
Putt-Putt	913.00	806.10	737.28
Vending, washers	956.31	1,156.52	1,953.08
Miscellaneous income	877.59	—	613.01
Other income:			
Assets sold (less cost)	—	17,961.96	—
Produce sold (less cost)	608.35	1,142.02	—
Land rent	—	3,600.00	7,500.00
Total income	60,968.78	79,637.50	70,248.22
Expenses:			
Labor	7,487.14	7,365.20	8,570.40
Payroll taxes	551.04	542.03	603.73
Linen	—	—	—
Utilities	6,049.35	5,099.25	5,054.34
Telephone	994.04	905.61	746.74
Supplies	7,158.25	6,559.01	5,681.93
Advertising	568.79	469.75	593.94
Dues and subscriptions	20.00	20.00	20.00
Discounts	—	—	—
Professional services	1,200.00	1,401.30	970.00
Insurance	3,723.56	2,863.67	4,645.90
Repairs	3,254.83	3,640.92	6,020.80
Interest	11,643.55	13,100.68	6,055.59
Taxes	1,585.61	1,507.85	1,795.22
Postage	63.65	40.62	45.20
Gas and oil	1,925.47	1,681.94	1,127.35
Lease (signs)	1,325.00	1,325.00	1,325.00
Miscellaneous	12.48	103.84	193.78
Donations	—	862.50	—
Franchise charge-off	—	7,500.00	—
Depreciation	7,460.69	8,900.79	9,561.47
Total expenses	55,023.48	63,889.96	53,011.41
Net income	$ 5,945.30	$15,747.54	$17,236.81

of equipment associated with these eight portable rooms. In early 1979, Brown developed Lakeview Inn and Campground brochures as shown in Exhibit 8 for distribution at welcome centers and other tourist stops along south I-75 between Macon and Valdosta, Georiga.

16 In 1980, Brown was notified by the Georgia Highway Department that all 12 of his interstate highway signs were in violation of current billboard laws. The violation pertained to their distances from the interstate right-of-way (they were too close) and/or the fact that each sign was in a noncommerical area. Brown appealed the highway department ruling and eventually was

exhibit 7

LAKEVIEW INN AND CAMPGROUND
Balance Sheets
For the Years 1978–1980

	1980	*1979*	*1978*
Assets			
Cash	$ 442.97	$ 9.20	$ 188.71
Franchise	—	—	7,500.00
Land	116,988.75	116,988.75	117,197.50
Personal residence	13,893.10	13,983.10	13,893.10
Fixed assets	183,677.02	183,443.02	195,440.61
Accrued depreciation	(148,988.98)	(141,528.29)	(148,008.50)
Prepaid interest	520.17	3,153.33	6,197.86
Total assets	$ 166,533.03	$ 175,959.11	$ 192,409.28
Liabilities and Net Worth			
Liabilities:			
Sales tax payable	$ 90.16	$ 78.42	$ 160.48
Payroll tax payable	204.84	147.62	284.36
Accounts payable	4,258.14	4,205,24	1,912.84
Notes and mortgage due (1 year)	27,016.15	25,299.76	23,761.84
Notes and mortgage due (over 1 year)	67,469.74	82,531.09	100,724.48
Total liabilities	98,039.03	112,262.13	126,844.00
Net worth:			
Calvin Brown (capital)	63,696.98	65,565.28	56,931.72
Add: Net income	8,120.99	15,747.54	17,236.81
Add: Life insurance cashed	10,000.00	—	—
Less: Drawings	13,323.97	17,615.84	8,603.25
Total net worth	68,494.00	63,696.98	65,565.28
Total liabilities and net worth	$ 166,533.03	$ 175,959.11	$ 192,409.28

allowed to keep 10 signs if he paid a $50 per year sign permit fee. While letting him keep the 10 signs, the highway department has not granted Brown's request that it remove the trees, planted on highway right-of-way in the early 1970s, that have now grown sufficiently high to effectively block the signs from the travelers' view. In the summer of 1981, Brown was still actively pursuing the removal of these trees.

exhibit 8
Lakeview Inn brochure

Calvin G. Brown

invites you to come

and enjoy the quiet

qualities at his

LAKEVIEW INN
and
CAMPGROUND

The Lakeview
Personnel Will Give
You A Hearty

Y'ALL COME
SEE US Y'HEAR

Lakeview
Inn

- *26 ROOMS AVAILABLE*
- *SOUTHERN ATMOSPHERE*
- *EASY ACCESS*
- *TV IN EVERY ROOM*
- *REASONABLE RATES*
- *HEAT & AIR CONDITIONING*
- *RESTAURANT 3 MILES*

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"Your Comfort
Is Our Creed"

NEXT TIME YOU TRAVEL
YOU WILL REMEMBER LAKEVIEW

Lakeview

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Georgia Agrirama Tifton
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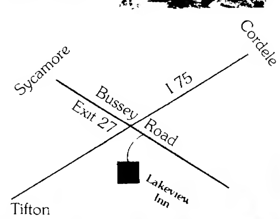

Lakeview
Inn
and
Campground

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EXIT 27

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Campground

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Index

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E

This book has been set VIP in 10 and 9 point Times Roman, leaded 2 points. Part numbers and titles are set in 30 point Times Roman, and chapter numbers and titles are set in 18 point Times Roman. The size of the type page is 28 by 48 picas.